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Emma Coleman Jordan

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Ending the Floating Check Game: The Policy Arguments For Delayed Availability Reform†

By EMMA COLEMAN JORDAN*

Increasingly, retail bank¹ depositors have encountered substantial periods of delay in gaining access to the proceeds of checks and other demand items that are in the process of collection.² At the heart of the problem is the inefficient method that banks use to process return items. Long delays in processing check returns leave banks uninformed about whether an item has been accepted or rejected by the payor bank. To diminish the risk of withdrawal of uncollected balances created by dishonored or fraudulent checks, banks withhold access to deposits.³ Thus,

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* Professor of Law, University of California, Davis. In writing this Article, Professor Jordan has drawn upon her experience as a drafter of the California Delayed Availability Statute, which suggests a comprehensive approach under state law to the problem of delayed funds availability.

I thank Pierre Loiseaux and Elizabeth Warren for thoughtful criticism of earlier drafts, and Ilene Goldstein Block for invaluable research assistance.

1. Throughout this Article the term "bank" has been used to describe all financial institutions providing deposit and check clearing services governed by the Uniform Commercial Code. For a functional definition of bank, see U.C.C. § 1-201(4) (1978).

2. There are several reports within the banking industry on the problems of delayed availability. See, e.g., AMERICAN BANKERS ASSOCIATION, 1984 RETAIL DEPOSIT SERVICES REPORT: A COMPARATIVE STUDY OF BANK ACTIVITIES 8-9, 41-42 (1985) [hereinafter cited as 1984 DEPOSIT SERVICES REPORT]; BANK ADMINISTRATION INSTITUTE, DELAYED AVAILABILITY RETURN ITEM TASKFORCE REPORT (1979) [hereinafter cited as RETURN ITEM TASKFORCE REPORT]; BANK ADMINISTRATION INSTITUTE, RETURN ITEM NOTIFICATION PROCEDURES: A TASK FORCE REPORT (1979) [hereinafter cited as NOTIFICATION PROCEDURES]; Bank Administration Institute, Position Paper: BAI Delayed Availability Task Force on Return Items (Nov. 1979), reprinted in *Delayed Funds Availability: Hearing Before the Subcomm. on Consumer Affairs of the Senate Comm. on Banking, Housing, and Urban Affairs*, 97th Cong., 2d Sess. 196 (1982) [hereinafter cited as Position Paper].

Further, consumer groups have conducted surveys of hold policies in selected geographic areas. See, e.g., *When Is It Your Money*, 49 CONSUMER REPORTS 648 (Nov. 1984); Consumer Action, Press Release: CA Releases Survey on Check Hold Policies 2 (June 14, 1983) (copy on file with the *Hastings Law Journal*) [hereinafter cited as Consumer Action]. The Survey is based upon a telephone survey of 55 financial institutions in the state of California.

3. A 1974 study, BANK ADMINISTRATION INSTITUTE, THE IMPACT OF EXCEPTION ITEMS ON THE CHECK COLLECTION SYSTEM (1974) [hereinafter cited as IMPACT OF EXCEP-

banks commonly delay the availability of uncollected funds for periods ranging from four to twenty-one banking days.⁴ Blanket delays, applicable to all deposits, are especially troublesome in light of the small number of items that ultimately are dishonored. For some financial institutions, the delayed availability policy also has become one of several tools to protect slim profit margins, which seem to be under attack from every quarter.⁵ Although there is no significant disagreement that financial institutions face some risk during the collection of items accepted for deposit, there is wide disagreement as to how these risks should be managed within the existing legal framework.⁶

TION ITEMS], reports that less than 1% of all checks processed are returned. The reasons for returned items are as follows:

Insufficient Funds & Refer to Maker	72%
Payment Stopped	3%
Account Closed	4%
Drawn on Uncollected Funds	1%
Signature	2%
Endorsement	6%
Other	12%

Id. at 25.

4. The Consumer Action survey of California financial institutions identified eight savings and loans which placed holds of 10-12 days on checks drawn on institutions in the same city. For checks drawn on banks outside the city of deposit, but within the state, holds range from 0-20 days. For out-of-state items the range was 4-21 days. Consumer Action, *supra* note 2, at 2; see also 1984 DEPOSIT SERVICES REPORT, *supra* note 2, at 8. This study indicates that 88% of banks with \$500 million or more in assets place holds on deposited items for uncollected funds. Smaller banks (assets less than 50 million dollars) are less likely to place holds. Only 43.4% of the smaller banks placed holds. The average hold that small banks place on out of state checks is nine days. *Id.* at 41.

5. Theodore E. Allison, Staff Director for Federal Reserve Bank Activities, Board of Governors of the Federal Reserve System, acknowledged the probable role of delayed availability in revenue production:

It is frequently charged that delayed funds availability practices are intended to generate increased revenues for depository institutions at the expense of depositors. It may well be that certain institutions are able to enhance their revenue through the practice of imposing blanket rather than selective delay policies. This would be true since blanket delay programs are relatively easy to implement and affect all or most checks deposited.

Delayed Funds Availability: Hearing Before the Subcomm. on Consumer Affairs of the Senate Comm. on Banking, Housing, and Urban Affairs, 97th Cong., 2d Sess. 4, 8 (1982) (testimony of Theodore E. Allison, Staff Director for Federal Reserve Bank Activities) [hereinafter cited as *Delayed Funds Availability Hearing*].

6. See, e.g., *Delayed Availability Problems of Banking Customers: Hearings on A.B. 1723 Before the California Senate Committee on Banking and Insurance*, (August 17, 1983) (statement of Emma Coleman Jordan, Professor of Law, University of California, Davis) [hereinafter cited as *California Delayed Availability Hearings*]:

There are three central features of the modern check collection system. *First* is the provisional credit concept *Second*, the midnight deadline concept, defined above, is used as a signal to each bank in the . . . collection chain, that it is too late

Predictably, bank customers have begun to insist on changes in the legal rules that permit abuses.⁷ Some argue that a few financial institutions have converted what is essentially a defensive tool into a technique that disadvantages many small depositors.⁸ Hold policies have their greatest impact on individuals and small businesses because large corporate depositors now effect large fund transfers electronically,⁹ thus avoiding the float problems that occur with paper collection.¹⁰

to reverse the process. The system operates on the principle that no news is good news. There is no message sent to confirm that a check has been paid. This fact is central to understanding the way the system works. We have structured the check collection system on the principle, borne out over more than 30 years of the Uniform Commercial Code, that most checks are good and will be paid. The success of that assumption is reflected in the fact that today more than 99.3% of all checks written are good and will be paid when first presented. This is quite an impressive fact, given the stability of these figures over time. A *third*, and related, aspect of check collection is that the system operates on the assumption that there will be a large volume of items going forward with relatively few coming back.

7. The level of consumer complaint has increased in recent years and reached its height during the hearings and public comment preceding the adoption of the California delayed availability law. Act of Sept. 21, 1983, ch. 1011, 1983 Cal. Legis. Serv. 5388 (West) (amending CAL. COM. CODE §§ 4212-4213 and supplementing CAL. FIN. CODE §§ 866.5, 866.6, 866.7, 866.9). In the course of debates preceding the adoption of the Act, Speaker Willie L. Brown, Jr., the author of A.B. 1723, received almost 10,000 individual written expressions of support for the proposed reform. Telephone interview with Kathleen Snodgrass, Legal Counsel to California Assembly Speaker Willie L. Brown, Jr. (May 26, 1983). Many of the correspondents cited personal difficulties with holds as the basis of their concern that the revisions succeed.

Further, an additional 8000 coupons and several hundred letters of protest were sent to the California Superintendent of Banking in response to an article which appeared in two San Francisco newspapers criticising proposed administrative regulations setting maximum hold periods. Mandel, *Consumer Alert*, San Francisco Examiner, June 17, 1984, at A2, col. 1. These comments were sent in response to proposed regulations authorized by the California Delayed Availability Law. See State of California State Banking Department, Final Statement of Reasons (1984) (statement of the reasons for the order adopting subarticle 5 of article 30 of subchapter 10 of chapter 1 of title 10 of the California Administrative Code) (copy on file with the *Hastings Law Journal*) [hereinafter cited as Final Statement of Reasons].

8. See *Delayed Funds Availability Hearing*, *supra* note 5, at 38-43 (statement of Robert J. McEwen, Department of Economics, Boston College).

9. See Scott, *Corporate Wire Transfers and the Uniform New Payments Code*, 83 COLUM. L. REV. 1664 (1983). Scott notes that:

according to 1980 figures, wire transfers—instructions that funds be transferred from one person to another implemented through electronic means—account for the movement of \$117 trillion each year. The average wire transfer is \$2 million, as compared with the average check of \$570 and the average bank card transaction is \$38.

Id. at 1664.

10. In general, the most sophisticated electronic fund transfer systems are not available directly for transactions by individual depositors. These systems include Fed Wire (available for inter-bank fund transfers within the Federal Reserve System), Bank Wire (communication and settlement service available only to depository institutions), and CHIPS (transfers and settlements among participating New York City banks). *Id.* at 1668-73.

Article four of the Uniform Commercial Code (U.C.C.) establishes the legal framework for bank collections. Accordingly, an inquiry into hold policies must address the basic question whether the U.C.C. provides a useful approach to the central problem of the timing of return item processing. In fact, the current difficulty arguably stems largely from a conceptual vacuum within the U.C.C. concerning the processing of return items. The controversy surrounding hold practices has provided an opportunity to reexamine the broad discretion permitted by article four of the U.C.C.¹¹

This Article proposes limits upon the wide discretion now given to financial institutions to determine when customers will be permitted to withdraw deposited funds as a matter of right. The Article concludes

11. U.C.C. § 4-213 (1978) states:

(1) An item is finally paid by a payor bank when the bank has done any of the following, whichever happens first:

- (a) paid the item in cash; or
- (b) settled for the item without reserving a right to revoke the settlement and without having such right under statute, clearing house rule or agreement; or
- (c) completed the process of posting the item to the indicated account of the drawer, maker or other person to be charged therewith; or
- (d) made a provisional settlement for the item and failed to revoke the settlement in the time and manner permitted by statute, clearing house rule or agreement.

Upon a final payment under subparagraphs (b), (c) or (d) the payor bank shall be accountable for the amount of the item.

(2) If provisional settlement for an item between the presenting and payor banks is made through a clearing house or by debits or credits in an account between them, then to the extent that provisional debits or credits for the item are entered in accounts between the presenting and payor banks or between the presenting and successive prior collecting banks seriatim, they become final upon final payment of the item by the payor bank.

(3) If a collecting bank receives a settlement for an item which is or becomes final (subsection (3) of Section 4-211, subsection (2) of section 4-213) the bank is accountable to its customer for the amount of the item and any provisional credit given for the item in an account with its customer becomes final.

(4) Subject to any right of the bank to apply the credit to an obligation of the customer, credit given by a bank for an item in an account with its customer becomes available for withdrawal as of right

- (a) in any case where the bank has received a provisional settlement for the item,—when such settlement becomes final and the bank has had a reasonable time to learn that the settlement is final;
- (b) in any case where the bank is both a depository bank and a payor bank and the item is finally paid,—at the opening of the bank's second banking day following receipt of the item.

(5) A deposit of money in a bank is final when made but, subject to any right of the bank to apply the deposit to an obligation of the customer, the deposit becomes available for withdrawal as of right at the opening of the bank's next banking day following receipt of the deposit.

that amendments to article 4 of the U.C.C. would be the most durable means of reform because article 4 is a uniform state law that establishes the basic framework for the national payment system. It governs collections and returns that are accomplished inside or outside of the Federal Reserve System. Moreover, the problem of delayed availability is closely related to the body of rules governing check collection; any well-crafted solution should be integrated into the U.C.C. as an amendment approved by the Permanent Editorial Board.

This Article examines three legal problems resulting from functional omissions from the U.C.C.: First, the U.C.C. neither specifies a means for returning items nor sets a clear standard for the kind of performance expected of banks within the chain of endorsement. The omissions are critical. Absent guidance from the statute for determining the maximum time allowable before funds must be made available, the standard of reasonableness is vague and therefore meaningless.¹² As a result, the accepted practice is to send returned items by the cheapest and least reliable method: the United States mail.¹³ Second, the U.C.C. permits payor banks to return a rejected item up the chain of endorsement to the next prior endorser,¹⁴ thus triggering a prolonged and often unpredictable sequence of events. Although direct return¹⁵ from the payor bank to the depository bank is a more efficient option, most financial institutions do not use this method. Their reluctance is based upon an uncertainty about what is required to charge prior intermediate endorsers.¹⁶ Third, there is at present no uniform, enforceable requirement that a payor bank must give a "wire notice" of return when it has decided not to pay an item.¹⁷ The present complex of uncertain rules surrounding the processing of return items has further contributed to the slowness with which return items are handled.

The Article considers the problem of delayed availability and pro-

12. The provisional credit given when an item is initially deposited is not available for withdrawal as of right until the "bank has had a *reasonable* time to learn that the settlement is final." U.C.C. § 4-213(4)(a) (1978) (emphasis added); see *infra* text accompanying notes 102-07.

13. See RETURN ITEM TASKFORCE REPORT, *supra* note 2.

14. U.C.C. §§ 4-301(1)(a), 4-301(4) (1978).

15. *Id.* § 4-212(2). Several states, including California, did not adopt this provision when it was initially proposed. The purpose of § 4-212 is to provide an opportunity for the payor bank to minimize the loss which ordinarily would fall on the depository bank if notice of dishonor and, under this section, the returned item itself are delayed.

16. *Id.* §§ 4-301(1)(a), 4-301(4).

17. See, e.g., *Wells Fargo Bank v. Hartford Nat'l Bank & Trust Co.*, 484 F. Supp. 817, 821-22 (D. Conn. 1980); *Nassau Trust Co. v. Bankers Trust Co.*, 28 U.C.C. Rep. Serv. (Callaghan) 1440 (N.Y. Sup. Ct. 1980); *Yeiser v. Bank of Adamsville*, 614 S.W.2d 338, 343 (Tenn. 1981).

poses remedial legislation. First, it analyzes the essential elements of the modern check collection system,¹⁸ focusing on the differences in the processing of the three categories of checks¹⁹ and describing the involvement of the Federal Reserve Bank in check collection.²⁰ The Article then examines the disparity between check collections and check returns.²¹ The discussion demonstrates that the delay in check return results in a delay in availability of funds and that such nonavailability, in conjunction with early provisional credits granted by the Fed, creates check float.²²

The Article next criticizes the U.C.C. approach to the consumer's right to withdraw funds.²³ The discussion analyzes the relevant provisions of the U.C.C. and concludes that the U.C.C. provides no means of correcting the problem with check float. The Article then identifies and discusses current obstacles to check processing reform. It considers problems regarding notification, the deference accorded a bank's business judgment, and the notable failure of attempts to litigate a resolution to delayed availability.²⁴

Despite these obstacles, the Article argues, considerations of fairness and efficiency require national reform of check processing procedures.²⁵ Depositors' expectations that funds will be available within predictable and short periods of time must be balanced against the obvious benefit to the financial system of reducing the risks from fraud and dishonor. Yet the discrepancy between the accurate and speedy handling of the large volume of items during initial forwarding to the payor bank and the slow, error-filled processing of the small number of dishonored items is unwarranted and unfair. That unfairness is exacerbated by blanket hold policies with discretionary exemptions for certain powerful bank customers.

Finally, the Article proposes legislative action to protect the banks' interests while also protecting consumers.²⁶ Section 4-213 of the U.C.C. should be revised to provide for state administrative regulation of maximum holds on uncollected deposits.²⁷ Definition of reasonable periods

18. See *infra* notes 30-50 & accompanying text.

19. The three types are on-us items, clearinghouse items, and transit items.

20. See *infra* notes 51-85 & accompanying text.

21. See *infra* notes 86-93 & accompanying text.

22. See *infra* note 94 & accompanying text.

23. See *infra* notes 96-107 & accompanying text.

24. See *infra* notes 122-78 & accompanying text.

25. See *infra* notes 108-21 & accompanying text.

26. See *infra* notes 179-223 & accompanying text.

27. This is the approach adopted in California. Act of Sept. 21, 1983, ch. 1011, 1983 Cal.

for delay in the availability of funds, disclosure of hold policies, and notification of holds on individual transactions will diminish the element of surprise that is a source of depositor complaints. In addition, collecting and payor banks should be required to use the most expeditious means of processing return items; the banking industry might be motivated to make further improvements in the processing of return items. National reform is needed, and the recent experience in two states²⁸ suggests that such reform can succeed.

The Modern Check Collection System

Each year approximately thirty-five billion checks are processed for collection.²⁹ The process begins at the bank of deposit and, if the check is paid, ends at the bank on which the check has been drawn. The procedures and legal rules governing the handling of checks pending collection are a blend of banking industry custom, the requirements of the U.C.C., and Federal Reserve regulations. A brief description of the way in which checks are collected sets the stage for assessing the possibilities for delayed availability reform.

The Initial Collection of a Check

A check that has been accepted for deposit falls in one of three categories: the on-us item, the clearinghouse item, and the transit item. A description of each of these follows.

On-Us Items

On-us items, checks that have been drawn on and deposited in the same institution, represent slightly more than one-half of all checks written.³⁰ When a teller accepts an on-us item, the depositor is given a reversible bookkeeping credit called a "provisional credit."³¹ In the absence of dishonor, this temporary credit will become final with the pas-

Legis. Serv. 5388 (West) (amending CAL. COM. CODE §§ 4212-4213 and supplementing CAL. FIN. CODE §§ 866.5, 866.6, 866.7, 866.9).

28. *Id.*; N.Y. BANKING LAW § 14-d (McKinney Supp. 1984-1985).

29. GENERAL ACCOUNTING OFFICE, COMPTROLLER GENERAL'S REPORT TO THE CONGRESS: THE FEDERAL RESERVE SHOULD MOVE FASTER TO ELIMINATE SUBSIDY OF CHECK CLEARING OPERATIONS (May 7, 1982) [hereinafter cited as COMPTROLLER GENERAL'S REPORT].

30. See COMPTROLLER GENERAL'S REPORT, *supra* note 29; *Delayed Funds Availability Hearings*, *supra* note 5, at 4.

31. "'Settle' means to pay in cash, by clearing house settlement, in a charge or credit or by remittance, or otherwise as instructed. A settlement may be either provisional or final." U.C.C. § 4-104(j) (1978); see also B. CLARK, *THE LAW OF BANK DEPOSITS, CHECK COLLECTIONS AND CREDIT CARDS* § 4.9, at 4-60 (rev. ed. 1981).

sage of an unspecified length of time after the deposit was initially accepted. Establishing the time of final payment is important because, even for on-us items, a customer is not entitled to withdraw funds until the item has been paid.³²

The U.C.C. determines when the entry becomes final.³³ For an on-us item, the provisional credit becomes final and the depositor has a right to withdraw "at the opening of the bank's second banking day following receipt of the item."³⁴ Thus, more than half of the checks written today ordinarily do not present delayed availability issues because the U.C.C. has set a definite time³⁵ after which customers can draw on these funds as a matter of right.

This fixed deadline, the opening of business of the second banking day after receipt, accommodates both the bankers' and the customers' expectations that funds will be made available within prescribed, definite times. Because the decision to pay items drawn on the institution in which they are deposited can be made and communicated quickly, the availability of these funds can be determined within statutorily defined time periods. Thus, for on-us transactions, the U.C.C. acknowledges that a fixed time period is an appropriate measure of the legal obligation of banks to make funds available to their customers.

Clearinghouse and Transit Items

A clearinghouse is an arrangement between banks in the same city or region to exchange checks at a regular, predetermined time.³⁶ Depository and collecting banks³⁷ present checks for payment to other collect-

32. U.C.C. § 4-213(4)(b) (1978) (emphasis added) provides that credit becomes available for withdrawal as of right "in any case where the bank is both a depository bank and a payor bank and the item is *finally paid*,—at the opening of the bank's second banking day following receipt of the item."

33. Final payment has occurred when one of the events listed in § 4-213(1) has taken place, thus rendering the payor bank accountable. *See supra* note 11.

34. U.C.C. § 4-213(4)(b) (1978).

35. The midnight deadline is another standard, based on time, for assessing the performance of collecting banks. The "midnight deadline" with respect to a bank is midnight on its next banking day following the banking day on which it receives the relevant item or notice or from which the time for taking action commences to run, whichever is later. *Id.* § 4-104(1)(h); *see also id.* § 4-202(2).

36. For a description of modern clearinghouse arrangements, see Frodin, *Fed Pricing and the Check Collection Business: The Private Sector Response*, BUS. REV., Jan.-Feb. 1984, at 15. For a description of early clearinghouse arrangements, see W. SPAHR, *THE CLEARING AND COLLECTION OF CHECKS* 103 (1926).

37. "'Depository bank' means the first bank to which an item is transferred for collection even though it is also the payor bank." U.C.C. § 4-105(a) (1978). "'Collecting bank' means any bank handling the item for collection except the payor bank." *Id.* § 4-105(d); *see infra* note 43.

ing or payor banks at these clearinghouse exchanges. The Federal Reserve is a major clearinghouse, although private clearinghouses are also common.

The exchange of checks within citywide clearinghouses is still done the old-fashioned way. In New York City, for instance, the New York Clearing House, an association of twelve banks, serves as the location for messengers representing clearinghouse member banks to meet and exchange checks that have been cashed or accepted for deposit during the previous day. This face-to-face exchange of bundles of checks, which have been sorted according to the bank on which the item is drawn, is completed within a matter of minutes. The net position³⁸ of each bank at the end of the exchange is determined by a computerized calculation. Each bank is credited for checks and items it has presented for payment and debited for items presented by other banks for payment. Settlement—an accounting between banks for items exchanged—is executed by virtue of a net credit or debit to each bank's Federal Reserve account balance.³⁹

The operation of the clearinghouse is determined by clearinghouse rules. These rules are essentially a contract among the member banks. Unlike ordinary contracts, however, the clearinghouse rules are binding on *depositors*, even though the depositors have neither read them, nor know of their existence.⁴⁰ Section 4-103(2) of the U.C.C. gives such rules the "effect of agreements . . . , whether or not specifically assented to by all parties interested in items handled."⁴¹

Checks drawn on banks in a different region, city, state, or outside

38. See generally Leary, *Check Handling Under Article 4 of the Uniform Commercial Code*, 49 MARQ. L. REV. 331 (1965); Malcolm, *How Bank Collection Works*, 11 HOW. L.J. 71 (1965).

39. For a description of the check exchange at the New York Clearing House, see Ross, *The Race is to the Slow Payer*, FORTUNE, Apr. 18, 1983, at 75.

40. See J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 555 n.12 (1972).

41. U.C.C. § 4-103(2) (1978). Comment 3 to this section expressly endorses a role for clearinghouse rules:

Local clearing houses have long issued rules governing the details of clearing; hours of clearing, media of remittance, time for return of mis-sent items and the like. The case law has recognized such rules, within their proper sphere, as binding on affected parties and as appropriate sources for the courts to look to in filling out details on bank collection law. Subsection (2) in recognizing clearing house rules as a means of preserving flexibility continues the sensible approach indicated in the cases. Included in the term "clearing houses" are county and regional clearing houses as well as those within a single city or town. There is, of course, no intention of authorizing a local clearing house or a group of clearing houses to rewrite the basic law generally. The term "clearing house rules" should be understood in the light of functions the clearing houses have exercised in the past.

the United States, are called transit items.⁴² These items are handled in very much the same way as clearinghouse checks, although longer periods of time are required for forwarding these items because they must move through several regions before reaching their destination at a payor bank.⁴³

The depositary bank has several options for how it forwards the transit item for collection. The depositary may choose to forward the item to a collecting bank with which it has an account. The check will in turn be forwarded through a series of collecting banks to the payor bank on which it has been drawn. During the transfer to the payor bank, the item will receive provisional credit at each stop along the way. The credits become final either when the payor bank has taken some positive action to indicate that the item has been paid, or when the midnight deadline has passed.⁴⁴ If the item is honored, the payor bank need not do anything to firm up the provisional credits entered during the process of collection. These credits automatically become final without further action.⁴⁵ The payor bank need not communicate the fact of payment to anyone other than the customer on whose account the item is drawn.⁴⁶

A second option open to the depositary bank is to forward the item directly to the payor bank by mail.⁴⁷ If the depositary bank chooses to mail the check directly to the payor bank, the depositary will give a provisional credit to the depositor's account pending final payment. The de-

See *infra* note 177 for a discussion of the impact of § 4-103(1) on depositors' efforts to secure early availability.

42. See W. SPAHR, *supra* note 36, at 448 (transit item background).

43. " 'Payor bank' means a bank by which an item is payable as drawn or accepted." U.C.C. § 4-105(b) (1978).

44. See *supra* note 35.

45. See U.C.C. § 4-212 comment 1 (1978):

Under current bank practice, in a major portion of cases banks make provisional settlement for items when they are first received and then await subsequent determination of whether the item will be finally paid. This is the principal characteristic of what are referred to in banking parlance as "cash items." Statistically, this practice of settling provisionally first and then awaiting final payment is justified because more than ninety-nine percent of such cash items are finally paid, with the result that in this great preponderance of cases it becomes unnecessary for the banks making the provisional settlements to make any further entries. In due course the provisional settlements become final simply with the lapse of time.

46. *Id.*

47. The direct routing practice was expressly disapproved in early common law decisions holding that it was against public policy and therefore negligent per se. In fact, the stated reasons for this pre-U.C.C. rule of negligence are quite understandable. The primary concern seems to have been the risk of failure of the drawee bank during the period of collection. It was feared that a drawee bank in failing condition would defer action on mail presentments for days, while paying out the majority of its cash in the interim. This, of course, would disadvantage the payee of the mailed item. See J. MORSE, A TREATISE ON THE LAW OF BANKS AND

positary bank in turn will receive a provisional credit from the bank that it has chosen for forwarding the item to the distant payor. Typically, the agent for collection is the nearest Federal Reserve Bank.

The commentary to section 4-212 of the U.C.C. recognized that direct return was a new practice that was just beginning to develop. Accordingly, the rule permitting direct returns was made an optional provision of the U.C.C.⁴⁸ This method of return was intended

to speed up the return of unpaid items by avoiding handling by one or more intermediate banks. . . . [T]he practice is not yet well established and some bankers and bank lawyers would prefer to let the practice develop by agreement. The contention is made that substantive rights between banks may be affected, e.g. available set-offs, but proponents contend advantages of direct returns outweigh possible detriments.⁴⁹

The section was thus included to grant banks greater flexibility.⁵⁰

The Federal Reserve System

The Role of the Federal Reserve in the Check Collection Process

As previously noted, the Federal Reserve (the Fed) is a major clearinghouse, processing approximately forty percent of all checks written in the United States.⁵¹ The overall speed and safety of the American check clearing system is largely attributable to the reliable national network made available for check clearing by the Fed.⁵² Federal Reserve

BANKING § 236 (6th ed. 1928); see also Turner, *Bank Collections—The Direct Routing Practice*, 39 YALE L.J. 468, 471-72 (1930).

The U.C.C., however, expressly approves the practice today. Thus, cases such as *Winchester Milling Co. v. Bank of Winchester*, 120 Tenn. 225, 111 S.W. 248 (1908), were rejected with the adoption of § 4-212(2), which endorsed the option of direct returns.

48. U.C.C. § 4-212(2).

49. *Id.* § 4-212 comment 4.

50. There has been a recent resurgence of direct exchanges, which one commentator attributes to disincentives for using the Fed created by the introduction of pricing for check clearing services. Frodin, *supra* note 36, at 13.

51. See *Delayed Funds Availability Hearing*, *supra* note 5, at 5 n.2 (testimony of Theodore E. Allison, Staff Director of Federal Reserve Bank Activities). This figure assumes even greater importance upon considering the fact that approximately 50% of all checks are on-us items that have been deposited in the same bank on which they were drawn and therefore do not require any clearing at all. COMPTROLLER GENERAL'S REPORT, *supra* note 29.

52. The importance of the Federal Reserve in the check clearing system is acknowledged in U.C.C. § 4-103 (1978). See B. CLARK, *supra* note 31, at 4-64. Regulation J sets the standard of care for banks which send items through the Fed. In general, compliance with the terms of Regulation J will be sufficient to meet the standards for check collection stated in article four.

In virtually every significant aspect, Regulation J and article 4 of the U.C.C. are in accord on the rules governing check collection. There are, however, several areas in which the U.C.C. and Regulation J differ. For example, Regulation J provides that the Fed is not an agent or

check clearing services are now available to all banks, whether or not they are members of the system.⁵³

When the Federal Reserve system was inaugurated, banking was beset by many unsound practices. Chief among these was the practice of circuitous routing.⁵⁴ To alleviate these abuses, an efficient nationwide

subagent of the owner of the item, but rather acts only as the sending bank's agent for collection. 12 C.F.R. § 210.5(a) (1984). Thus, unlike other banks, the Fed is immunized from a direct action by the owner of an item for negligence in collection. *See, e.g., Colonial Cadillac, Inc. v. Shawmut Merchants Bank*, 28 U.C.C. Rep. Serv. (Callaghan) 760 (D. Mass. 1980). The court in this case held that the payee of a draft could not sue the Federal Reserve Bank of Boston for negligence in handling the draft. The court concluded that § 210.6 of Regulation J immunized the Fed from negligence liability to the sender of the item because it was not an agent or subagent of the payee-owner. The supremacy clause required that the conflict between article 4 and § 210 be resolved in favor of the provisions of Regulation J.

There has been one significant area of controversy concerning the relationship between article 4 of the U.C.C. and Regulation J. The court in *Community Bank v. Federal Reserve Bank*, 500 F.2d 282 (9th Cir. 1974), held that Federal Reserve Regulation J had the effect of an agreement that was binding, without assent, on any bank which used the Fed check clearing service. In this case the plaintiffs were several California banks that were not members of or participants in the Fed collection system. They challenged a 1972 amendment to Regulation J which required that settlement be made on the day the item was received by the Fed, rather than by midnight of the day after receipt, as permitted in the U.C.C. They also objected to the elimination of bank drafts as a permissible form of settlement. The court concluded that the conflict between the Fed requirements and the more liberal provisions of the U.C.C. had been avoided by the presence of § 4-103 which provided that the terms of the U.C.C. could be varied by agreement, whether or not assented to by the parties. *Id.* at 286-88. This provision had heretofore been applied to bind depositors to the terms of clearinghouse agreements. The court found that Regulation J was also an agreement which varied the terms of the U.C.C. and could therefore be given effect against nonmember banks that chose to use the Fed clearing service, without conflict. *Id.* at 286-87. The court rejected the argument that the payor bank plaintiffs were not bound by Regulation J because they were nonmembers. The court viewed their voluntary use of the Fed collection system as conduct which triggered the application of § 4-103. *Id.* at 287-88.

53. Initially, Federal Reserve check clearing was available to member banks only. In 1971, nonmember banks were given direct access, without having to send checks first to a member bank. COMPTROLLER GENERAL'S REPORT, *supra* note 29, at 1.

54. *See* W. SPAHR, *supra* note 36, at 103. "[T]he greatest evil in connection with the collection of out-of-town checks . . . [is] the practice of sending them on long, devious and circuitous routes in order to avoid remittance charges." *Id.* The author observes that the Federal Reserve Act of 1913, ch. 6, 38 Stat. 251 (1913) (codified at 12 U.S.C. §§ 221-228 and 31 U.S.C. § 409 (1982)) was adopted, at least in part, to intervene in the system of private contracts which produced the following abuses: (1) excessive charges, (2) indirect routing of checks to avoid remittance charges, (3) immediate credit for uncollected funds, (4) interest payments on uncollected funds, (5) compensating balances left with collecting banks solely to obtain part payment, (6) maintenance of reserve balances with banks for the sole purpose of getting items on which to charge exchange, (7) excessive gold movements, and (8) absorption of collection charges by collecting banks. *See* W. SPAHR, *supra* note 36, at 101-02.

Professor Scott, however, argues that there is no evidence that the abuses identified by Spahr were the reason for federal intervention. He notes that many of the practices were already in the process of elimination. Scott, *The Risk Fixers*, 91 HARV. L. REV. 737, 748-61 (1978).

check clearing system was designed based on processing within geographical zones.⁵⁵ Today, the Federal Reserve processes checks through a highly automated network of forty-eight regional processing centers.⁵⁶ The geographical organization of the Federal Reserve check clearing system creates some economies of scale because most of the checks processed by a regional processing center are drawn on banks within the same region.⁵⁷ The use of state-of-the-art banking technology also enhances efficiency. The centers are connected by chartered air couriers and wire services dedicated exclusively to the Federal Reserve check clearing business.⁵⁸ High-speed check sorting is accomplished by using machine-readable magnetic encoding (Magnetic Ink Character Recognition, MICR) on checks. This technique automatically identifies the amount of the check and the Federal Reserve zone in which the payor bank is located. Modern technology also speeds the handling of bundles of checks accompanied by cash letters.⁵⁹

From its inception, the Fed was designed to encourage banks to use the Federal Reserve system rather than the private clearinghouses or correspondent banks. Several incentives were used to make the Fed a more attractive clearinghouse. These incentives included immediate provisional credit on all eligible collection items cleared through the Fed.⁶⁰ The decision to give immediate provisional credit was justified by the assumption that the majority of collection items would be honored and that very few would be charged back because of dishonor.⁶¹ Initially, as a precaution, immediate credit was not counted as a part of the bank's reserve requirement⁶² and was not available for withdrawal until the item actually was paid.⁶³ Later, withdrawals against uncollected funds were permitted before confirmation of payment, and credit was made available for withdrawal according to a schedule based upon the customary times for receiving notice of dishonor from any given geographic point.⁶⁴ On

55. See W. SPAHR, *supra* note 36, at 179 (background on the zone system).

56. Frodin, *supra* note 36, at 15 n.2.

57. COMPTROLLER GENERAL'S REPORT, *supra* note 29, at 2.

58. *Id.*

59. The cash letter includes a dollar amount for each check in the bundle covered by the receipt and processed by the Federal Reserve. Checks are required to be grouped by geographic region because the availability of funds will depend upon the availability schedule assigned to the region for the group. *Id.*

60. See W. SPAHR, *supra* note 36, at 308; Turner, *supra* note 47, at 469.

61. See *supra* note 6.

62. See W. SPAHR, *supra* note 36, at 179-80.

63. *Id.* at 180-81.

64. Each of the 12 Federal Reserve banks adopted its own schedule indicating the period which must elapse before items subject to it could be available to be drawn against in the cash reserve account. In 1920 the Federal Reserve Board approved an interdistrict time schedule

the basis of this schedule, banks clearing through the Federal Reserve were permitted to count these deposits toward their reserve requirements after the fixed period identified in the schedule had elapsed.⁶⁵

Today, immediate credit is available for intra-city and intra-regional checks. Credit on all other checks is available within one to two days.⁶⁶ Until July 1983, two days was the maximum period for deferred credit to banks when the items were cleared through the Federal Reserve. In July 1983, the Board of Governors of the Federal Reserve adopted a system of fractional availability in which the cost of float is reflected in the schedule of availability for each item.⁶⁷ Now, part of an institution's credit for a deposit is deferred an additional day. The fraction is determined so as to set the average float for the institution at zero.⁶⁸

*Settlement: The Role of the Reserve Account*⁶⁹

Settlement for items cleared through Federal Reserve channels oc-

which served as the common framework for all of the 12 districts. As a result of the "average," rather than *actual*, transport or collection time schedule, Federal Reserve banks carried float. *Id.*

65. For example, a bank to which a one-day availability had been assigned would be entitled to treat an item as part of the cash reserve requirement on the first day after it was deposited. In the event the item were dishonored, the depository bank would be subject to a reversal of the earlier credit and the reserve balance would be accordingly reduced. Turner, *supra* note 47, at 470 (citing *Pascagoula Nat'l Bank v. Federal Reserve Bank*, 11 F.2d 866 (5th Cir.), *cert. denied*, 271 U.S. 685 (1926)).

66. COMPTROLLER GENERAL'S REPORT, *supra* note 29, at 2. The Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (codified in scattered sections of 12 U.S.C. (1982)) required the Federal Reserve to begin charging for its services, including the check clearing service. See generally Frodin, *supra* note 36, at 13. A policy of fractional availability was adopted to pass along the true cost of the check clearing operation and withdraw the subsidy formerly obtained from the federal treasury. *Id.*

67. Federal Reserve System, Reduction and Pricing of Federal Reserve Float, Docket No. R-0433 (Feb. 24, 1983)

68. *Id.*

The . . . plan proposed adjusting availability schedules on a fractional basis, as opposed to the traditional method of granting availability only in terms of whole days. [An availability schedule lists when a depository financial institution receives credit to its reserve account for different types of checks deposited with the Federal Reserve Bank for clearance.] For example, if 97% of check clearings between two Reserve Offices actually occur in one day and 3% in two days, then 97% of the dollar amount presented by depository banks clearing between these two offices would be credited the first day and 3% the second day. Thus, the 3% that regularly is not collected until the second day would be eliminated as float.

COMPTROLLER GENERAL'S REPORT, *supra* note 29, at 45.

69. Lawyers, even those in the commercial paper and banking fields, usually do not understand, or are uninterested in, the relationship of the reserve account to the check clearing system. The discussion that follows is a short description, for lawyers, of the procedures for settling checks through the collecting bank's reserve account with the Federal Reserve. A comprehensive analysis of the working of the reserve account is beyond the scope of this

curs through reserve accounts with the Federal Reserve bank in the geographic region. Banks that use the Federal Reserve clearing services are required to maintain running reserve accounts.⁷⁰ These accounts serve as the master accounting device for keeping track of the deposits and credits owed to each bank. At any given moment, every bank is both a depository or collecting bank for some items and a payor bank for others. Therefore, credits are given daily to depositing banks for items for which they are entitled to immediate availability and for all items to which deferred availability applies.⁷¹ Debits are entered for the total amount of checks presented for collection. At the end of the day a status report is compiled reflecting the net position of each institution. Adjustments include returned checks, arithmetic errors, and disputed items.⁷² The Federal Reserve provides banks with a fixed schedule of availability, which is not dependent upon *actual* collection time.

The credit given to the reserve account for items that have not actually been collected is in essence an interest-free loan, an advance provided to depositing institutions by the Federal Reserve. When the depositing bank has received a credit, although the paying bank has not yet been debited, Federal Reserve float is created.⁷³ The daily dollar value of this discrepancy has been valued at 3.2 billion.⁷⁴

The amount of float outstanding in the Federal Reserve check clearing system can have an important impact on the national economy. This is so largely because controlling reserve accounts is the principal way that the Federal Reserve monitors and restricts the growth of the money supply.⁷⁵ Uncontrolled increases in the amount of float may undercut the desired level of control of the money supply. In addition, the loss of revenue to the federal treasury attributable to float contributes to the federal deficit.⁷⁶ By one estimate, the average amount of float in a single

Article. I have included those aspects which are helpful in explaining check clearing and the delayed availability problems that are the focus of this discussion.

70. 12 U.S.C. § 248 (1982).

71. COMPTROLLER GENERAL'S REPORT, *supra* note 29, at 3.

72. *Id.*

73. Several reasons have been given for the existence of "Fed float": "peak workloads that exceed processing capacity, delays in transportation, or transportation schedules that do not permit collection within the time the Federal Reserve has allowed itself." *Id.* at 4; *see also* W. SPAHR, *supra* note 36, at 474-75; UNITED STATES BOARD OF GOVERNORS, THE FEDERAL RESERVE SYSTEM—ITS PURPOSES AND FUNCTIONS 192, 194 (1939).

74. COMPTROLLER GENERAL'S REPORT, *supra* note 29, at 4.

75. *Id.* at 43.

76. The Comptroller General estimates that "at current [1983] float levels, the Treasury is losing revenue at an annual rate of up to about \$400 million . . ." *Id.* He notes further that float is ultimately a cost to the taxpayers because it prematurely increases member bank reserves at the expense of Federal Reserve Interest income. *Id.*; *see also infra* note 66.

year was equal to approximately one eighth of the total reserve account balances then outstanding.⁷⁷

The Federal Reserve check clearing system also plays a dominant role in the soundness and efficiency of the banking system itself.⁷⁸ The extent to which immediate credit should be available to collecting banks from either the Fed or a correspondent has always been a matter of substantial controversy. During the early history of this country, the willingness of some clearinghouses to grant immediate availability and to permit member banks to treat these uncollected credits as cash was the source of instability.⁷⁹ Even after the Federal Reserve clearing system was in place, many private competitors continued to permit remittance by draft rather than cash for items in collection.⁸⁰ In addition, because correspondent banks typically give immediate ledger credit for cash letters received, nonmember banks are often able to meet a substantial proportion of state reserve requirements with uncollected funds and with compensating balances maintained with correspondents for other purposes. Even though immediate ledger credit may be given for cash letters, depositing banks are not free to draw on these funds until they are collected. The most important reason many banks continue to use the services of correspondents is the availability of immediate credit.

The Federal Reserve check clearing service is so vital to the banking industry that it has virtually controlled the terms and standards for check clearing since its inception in 1916.⁸¹ This position has been maintained because the Fed has been able to offer quick, reliable, nationwide clearing at rates that were subsidized by taxpayers. The early availability and at-par⁸² clearing service offered to banks clearing through the Fed

77. *Id.* at 43. The Comptroller General has qualified his assessment of the connection between float and monetary policy by noting that "the argument here is not that every variation in float is immediately offset by Federal Reserve Board Open Market transactions, but that open market policy accommodates the average float prevailing over a period of time." *Id.*

78. One commentator has noted that in the congressional discussion preceding the adoption of the Federal Reserve Act, "control of clearing by the [Federal Reserve Banks] was seen as a way to make member bank reserves a useful tool rather than an idle fund" Scott, *supra* note 54, at 748.

79. See W. SPAHR, *supra* note 36, at 109.

80. See, e.g., *Federal Reserve Bank v. Malloy*, 264 U.S. 160 (1924) (holding that it was negligent for a depository to accept bank drafts in payment from a collecting bank).

Today the U.C.C. approves payment by a remittance instrument. U.C.C. § 4-104(1)(j) (1978). However, comment 8 to § 4-213 makes it clear that final payment does not take place when the payor remits. Thus, final payment is postponed until the remittance draft is paid. This avoids creating accountability of the depository to its customer before the depository has been paid. See B. CLARK, *supra* note 31, § 4.10, at 4-62 to -63.

81. See W. SPAHR, *supra* note 36, at 165.

82. In 1916 "par collection" meant that checks could be collected at full face value

were among the early advantages which established this competitive position. Today these advantages are dwindling because the Fed has responded to the mandate of the Depository Institutions Deregulation and Monetary Control Act (MCA),⁸³ by pricing its check clearing services and improving efficiency to reduce the level of float in the Fed.

These recent changes in policy have resulted in the development of strong competition from private check clearing services.⁸⁴ In many instances, credit can be obtained for items that are still in the process of collection, within forty-eight hours after forwarding. In response to the Fed's decision to retreat from its longstanding policy of providing free clearing services and tax-subsidized, interest-free loans in the form of early availability to banks participating in the check clearing system, private clearinghouse and correspondent arrangements have become more attractive because they now provide the early availability formerly available from the Fed.⁸⁵

The Floating Check Game: The Need For Change

Return of Dishonored Checks

The treatment of check returns is dramatically different from that of check collections. When a check is forwarded for collection, it receives the benefit of jet couriers and expedited high speed processing. In sharp

through the Federal Reserve Bank with deductions when remitting. Collecting banks were expected to charge their customers for the expenses attributable to collection. W. SPAHR, *supra* note 36, at 193.

83. The Monetary Control Act of 1980, Pub. L. No. 96-221, 91 Stat. 132 (codified in scattered sections of 12 U.S.C. (1982)).

84. See Frodin, *supra* note 36, at 5. The author observes that the choices banks make at each stage of the check collection process depend on the following factors:

Two economic factors loom large—the cost of the service and quality The quality of service depends primarily on availability of funds, that is, how promptly a bank receives credit on checks it presents for collection. Promptness, in turn, depends on deposit, transportation, and availability schedules offered by various agents Early availability [was] particularly [important] for high dollar value checks.

Id.

Commercial check clearing studies now make shopping for the fastest and most advantageous check clearing arrangements quite feasible. Phoenix Hecht, Inc. of Chicago conducts one such study semi-annually that is designed to measure check presentation times to and from more than 150 banks. Letter from Daniel R. Morrissey, National Sales Consultant, Phoenix Hecht, Inc., to author (June 17, 1983) (copy on file with *Hastings Law Journal*).

85. Frodin, *supra* note 36, at 17-18.

The advent of pricing policies will also have a direct impact on delayed availability solutions. If changes in return item processing depend upon the creation of new Federal Reserve services, such as direct return through the Fed, this new service will also have to be priced to comply with the Monetary Control Act of 1980, Pub. L. No. 96-221, 91 Stat. 132 (codified in scattered sections of 12 U.S.C. (1982)).

contrast, items that have been returned, for whatever reason, are handled manually. Each returned item is read and sorted separately without the benefit of the MICR strip, which permits high speed sorting during the initial trip to the payor. Because this is a labor-intensive process, it is slower and more prone to human error. Highly skilled clerical staff are needed to decipher incomplete, missing, and partially obliterated endorsements, adding to the cost of processing.⁸⁶

Each item is then forwarded to the next prior collecting bank, rather than directly to the original depository bank. Because of the relatively small volume involved,⁸⁷ most dishonored checks are returned to the payor bank using the postal service, further increasing the risk of error.⁸⁸ The result is a highly inefficient method for returning items in which the risk of loss and delay increases exponentially⁸⁹ with each mailing to the next prior collecting bank.⁹⁰

The delays and inaccuracies in processing returned checks have a direct impact upon the availability of deposited funds. The check collection system operates on the premise that no news is good news. The depository bank has no inexpensive way of knowing precisely when an item has been paid. As a result, the vast majority of checks, some 99.3% of all items written, become final and are paid without any communication to any of the forwarding banks.⁹¹ Conversely, a depository bank will know that an item has been dishonored only when the check itself is returned after a lengthy series of transfers which retrace the original route for collection. The precise moment when a transit or clearinghouse item has been paid is so ambiguous that the depository bank has substantial discretion to restrict availability for periods often far in excess of the customary times for actual payment.

There are currently no real restraints on a bank's decision to with-

86. IMPACT OF EXCEPTION ITEMS, *supra* note 3, at 2-3.

87. The number of checks returned unpaid after presentment for payment has remained consistent. Less than one percent (approximately 0.67%) of the volume is subject to return processing. *See id.* at 23-29; *see also* U.C.C. § 4-212 comment 1 (1978).

88. The banking industry recognizes the additional risk created by using the postal service for return item processing. One industry report observed that "[a]nother factor compounding the delays caused by circuitous routing is that return items often flow through the mail system and are subject to the usual delays of the postal service." RETURN ITEM TASKFORCE REPORT, *supra* note 2, at 11; *see also* IMPACT OF EXCEPTION ITEMS, *supra* note 3, at 27 (five percent of the dollar losses incurred by banks participating in the study were due to returned cash letters and items lost in the mails on the way to the previous endorser).

89. The Bank Administration Institute reports that 39% of the dollar losses on return items experienced by banks were due to obliterated endorsements resulting from multiple handling and poorly maintained equipment. NOTIFICATION PROCEDURES, *supra* note 2, at 26.

90. *Id.*

91. U.C.C. § 4-212 comment 1 (1978).

hold funds.⁹² One of the most perplexing omissions from the U.C.C. is its silence concerning the method for returning items which have been dishonored. In fact, the U.C.C. section governing the customer's right to withdraw funds is so poorly drafted that it compounds the ambiguity, thus strengthening the bank's inclination to restrict availability.⁹³ This omission, more than anything else, has contributed to the present disarray. The U.C.C. is the only law that governs all check collections. It applies to collections completed outside the Fed clearing service and, through Regulation J, with few exceptions to items collected through the Fed.

The early availability based upon a provisional credit given to the depository bank by the first collecting bank is a benefit which might be passed along to depositors. When, however, a financial institution chooses to withhold customers' access to uncollected funds while enjoying the financial benefits of early availability granted by collecting banks, float has been created.⁹⁴ Float has become a permanent fixture of the paper payment system because financial institutions have found it difficult to resist taking advantage of the inevitable delay involved in physically transporting checks. Thus, some segment of the financial services industry always benefits from the early availability provided by check clearers, without passing the benefit along to the depositors of the 99.3% of checks which are paid when first presented.⁹⁵

The Customer's Right to Withdraw Deposits Under the U.C.C.⁹⁶

Curiously, the law governing check collection, return item processing, and delayed availability has proven to be irrelevant to abusive restrictions on availability. The U.C.C. provides no meaningful comment on this practice even though many of the problems described in this Article emerged before the U.C.C. was drafted. Moreover, the section that bears most directly on the problem disguises, and thereby distorts, basic

92. A federal joint policy statement calling for voluntary elimination of blanket delayed availability policies was recently issued. Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, and the Board of Governors of the Federal Reserve, Policy Statement, Delayed Availability of Funds (Mar. 22, 1984) (copy on file with the *Hastings Law Journal*) [hereinafter cited as Policy Statement]. Voluntary corrective action by banks is hardly sufficient given the magnitude of the current problem.

93. See *infra* note 106 & accompanying text.

94. See *infra* notes 111-13 & accompanying text.

95. IMPACT OF EXCEPTION ITEMS, *supra* note 3, at 5.

96. When does a customer have a right to withdraw funds subject to a provisional credit? In most states today, a none-too-cynical answer might be: when the bank says you may withdraw.

aspects of the check collection process.⁹⁷ In fact, section 4-213(4)(a) has proven to be a formidable shield for banks wishing to justify indefinite holds.

The U.C.C. does not prohibit a financial institution from giving uncollected fund withdrawal privileges to a customer. That decision is exclusively a business prerogative based upon assessment of creditworthiness and other elements of risk. In fact, many banks routinely grant immediate availability to some customers and refuse to do so for others.⁹⁸

When a check has been processed through the customary route of a clearinghouse or Federal Reserve Bank, the provisional settlements⁹⁹ become final when the item has been finally paid by the payor/drawee bank. Final payment is a magic moment in the law of check collections and deposits, and the focal point of many disputes. Final payment under the U.C.C. may occur through inaction, due to the passing of the mid-night deadline,¹⁰⁰ or by action, such as payment in cash.¹⁰¹

The moment of final payment is important because it signals the point at which the payor bank is accountable for the amount of the item.¹⁰² More important, under section 4-213(4)(a) final payment is also the point at which a customer is entitled to withdraw funds.¹⁰³ The U.C.C. provides that customers can withdraw funds as a matter of right only after final settlement has been made *and* "the bank has had a reasonable time to learn that the settlement is final."¹⁰⁴ This second qualification sets up a zone of ambiguity that can be used to thwart customers'

97. See *supra* note 11.

98. Commercial customers, for instance, are almost universally exempt from hold policies applied to personal accounts. See NOTIFICATION PROCEDURES, *supra* note 2, at 6 ("Although banks place holds based upon collectibility this is not always adhered to for commercial customers because of competitive pressures."). Theodore E. Allison, in his statement to the Subcommittee on Consumer Affairs, noted that "commercial customers generally have negotiated availability arrangements with their banks. They may get immediate availability, but have minimum balance requirements . . ." *Delayed Funds Availability Hearing, supra* note 5, at 24.

99. See *supra* note 31.

100. See *supra* note 35.

101. Section 4-213 defines the moment of final payment as the time when the payor bank has either (a) paid in cash; (b) settled for the item without reserving, or having by law or agreement, a right to revoke; (c) completed the process of posting the item; or (d) made a provisional settlement and failed to revoke it within the time permitted by statute or agreement. U.C.C. § 4-213 (1978).

102. *Id.* § 4-302. For a discussion of the question of when an item is finally paid, see generally Note, *Bank Collection Under the Uniform Commercial Code*, 38 IND. L.J. 710 (1963).

103. See Note, *supra* note 102, at 720-25.

104. U.C.C. § 4-213(4)(a) (1978); see *supra* note 11.

efforts to withdraw the deposit.¹⁰⁵

The operative maxim of the check collection system is that "no news is good news." No notice is given when an item is finally paid. Therefore, the language of section 4-213(4)(a) is at best inartful and at worst actively deceptive. The depository bank will *never* learn directly that an item has been finally paid.¹⁰⁶ Thus, it does not need "a reasonable time to learn" of the fact of final payment. The only reliable confirmation of the disposition of a check is the returned check itself and any notice which might accompany it. Section 4-213, however, permits banks absolute discretion to determine when the risk of return is minimal or non-existent. There are no standards for determining whether the depository banker's assessment of the risk is reasonable. Under the U.C.C., a bank may hold a depositor's money for an indefinite period in anticipation of delays attributable to the financial community's own refusal to use modern methods for returning checks.¹⁰⁷

The Policy Arguments for Delayed Availability Reform

Return item processing, which is slow, unpredictable, and error-ridden, is the chief justification for maintaining discretion to delay availability. Supporters of aggressive delayed-availability policies argue that depository banks must delay access to funds during collection because the processing of return items is fraught with delay and error.¹⁰⁸ No one disputes that description; every knowledgeable observer recognizes that return item processing is a persistent problem. The advocates of reform, however, are unwilling to concede the inevitability of these problems. To the contrary, return item processing is an ideal target for delayed availability reform.¹⁰⁹

Two principal arguments support legislative intervention to limit the authority of financial institutions to hold deposits for indefinite periods of time. First, holding deposits is unfair to depositors. An examination of the check clearing system reveals that banks which use the Fed have

105. The right to withdraw funds for which final payment has not been clearly determined is important only to those customers whose accounts have dropped below the amount of the recent deposit. Thus, many customers with balances well above the amount of an item deposited may be unaware of the delayed availability.

106. There are, of course, good and defensible reasons why notice of final payment is never sent. If the 99.3% of all checks which are honored on the first presentation were the subject of notice of payment, the check collection system would grind to a halt.

107. See *infra* notes 193-95 & accompanying text for a discussion of recent changes to the U.C.C. that have been adopted in two states to address the float, or delayed availability, problem.

108. See Policy Statement, *supra* note 92, at 2.

109. See RETURN ITEM TASKFORCE REPORT, *supra* note 2, at 1-11.

enjoyed early availability for items collected through the Fed.¹¹⁰

The Fed and other check clearers are willing to grant provisional credit, available immediately or within a short period of time, because ninety-nine percent of all checks issued are paid the first time presented.¹¹¹ This exceptionally high percentage of confirmed payment assures that the balance of risk favors the depositary bank. The near certainty that an item will be honored thus contradicts the argument in favor of hold policies as defensible protection against significant risks of loss. If the risk of loss is not significant, depriving depositors of the use of these funds for unregulated periods of time seems unfair. The typical bank depositor is entitled to the presumption of creditworthiness which underlies the decision to permit withdrawal before the payment has been confirmed or assumed.¹¹² Moreover, under the present scheme a perception of unfairness is buttressed by the obvious economic benefit to financial institutions who adopt an aggressive policy of holding funds.¹¹³

The second argument in support of reform addresses the efficiency of the system for processing returned items. Return item processing is the Achilles' heel of the paper payments system because it is slow, poorly managed, and fraught with unnecessary risks and delay.

Four problems emerge as persistent sources of frustration in the processing of return items. First, lack of uniformity in the method of return is a primary difficulty. The U.C.C. does not specify how return items should be sent back to the depositary bank; it only requires that

110. See *supra* text accompanying notes 66-68.

111. IMPACT OF EXCEPTION ITEMS, *supra* note 3, at 5.

112. If permitting withdrawal before confirmed payment entails risk because it may become a loan when the item is later returned, then perhaps the substantial insufficient funds check charges imposed on the small number of returning items compensate quite generously for that risk.

113. The amount of profit that banks derive from float has proven to be quite elusive, as the following exchange illustrates:

Senator Dodd: "I'm wondering why you didn't have in your testimony some estimate of how much the banks make on the float? While we do have estimates on the losses from uncollected funds, . . . you don't have any estimate on the amount made on the float; is that correct?"

Mr. Allison: "Well that's really an impossible thing to say . . . you would have to make some assumptions about what would happen to those deposits if it were not for the hold."

Delayed Funds Availability Hearing, supra note 5, at 23 (statement of Theodore E. Allison, Staff Director for Federal Reserve Bank Activities).

Mr. Allison later wrote to Senator Dodd to report that members of the Fed staff had developed a formula, which he considered to be only "an approach to calculating such revenues, the actual calculation cannot be performed without considerably more information, much of which would be difficult or impossible to obtain." *Id.* at 30.

each bank handling the item comply with its midnight deadline.¹¹⁴ Second, there is no requirement that items be returned from the payor bank directly to the depository bank. Although the U.C.C. contains an optional provision¹¹⁵ permitting direct returns, it is seldom used.¹¹⁶ Third, the payor has no obligation to send the depository bank immediate notification by telephone¹¹⁷ of dishonor.¹¹⁸ The fourth cluster of problems concerns the efforts to determine the identity of the endorers. Errors introduced during the initial processing of the item cause much of the delay in its return. It is commonplace for three to four¹¹⁹ collecting banks to handle an item before it reaches the payor bank. On the back of the check, each bank has placed an endorsement that is often impossible to read.¹²⁰ This problem is compounded when the later endorsements obscure those stamped earlier.¹²¹

In sum, the banks, lacking guidance from the U.C.C., have developed a system for processing return items that entails manipulations by a series of banks before the depository bank is informed of the return. The inefficiencies in these methods are the target of reform efforts.

114. See *supra* note 35.

115. U.C.C. § 4-212(2) (1978) provides: "Within the time and manner prescribed by this section and Section 4-301, an intermediary or payor bank, as the case may be, may return an unpaid item directly to the depository bank and may send for collection a draft on the depository bank and obtain reimbursement." Comment 4 accompanying § 4-212(2) indicates that direct returns are an innovation about which there was controversy. Some felt that direct returns should not be addressed by the U.C.C., but left to develop by agreement among banks.

116. The California delayed availability reform included a long overdue adoption of the optional subsection 2 of U.C.C. § 4-212.

117. "Wire notice" of return is the term applied within the banking industry to cable, telegraph, or other electronic communication. In most cases, however, the notice is sent by telephone. Mulford, *The Federal Reserve's "Wire Advice of Nonpayment": What It Is, What It Should Be*, 100 BANKING L.J. 622, 624 (1983).

118. Various notification proposals permit the payor bank to communicate the fact of dishonor without being dependent upon the the belated return of the item itself. The payor, however, would have to absorb the cost of notice initially. This will be true when, for example, the payor must assign clerical staff to the task of initiating the telephone call after a careful examination of the endorsements. Thus, the payor will absorb both the cost of the telephone call and the administrative and personnel costs. These costs cannot be passed on by imposing a fee directly based upon the cost of the service because the payor in this circumstance would be under legal obligation to send the notice.

119. Although the average number of handlings was estimated at 2.6 per check in 1973, this figure can easily be exceeded when the item has been sent forward for collection through a circuitous route. See *IMPACT OF EXCEPTION ITEMS*, *supra* note 3, at 2.

120. Missing or inadequate endorsements account for 6% of the dollar loss on return items that prove to be uncollectable. *NOTIFICATION PROCEDURES*, *supra* note 2, at 26.

121. Obliterated endorsements created during successive handlings are responsible for a staggering 39% of the dollar losses for returned items. *Id.*

Options for Reform: A Critique

The Problem of Notification

One option for improving the system for processing return items is to separate the physical return of the check from the process for serving notice that the check has been dishonored. Although the U.C.C. does not require wire advice of nonpayment, the Federal Reserve has such a requirement,¹²² and a number of proposals mandating a general "wire advice" of nonpayment have been discussed.¹²³ Essentially the payor bank or the Federal Reserve would be required to inform the depository bank by telephone that an item was being returned.

The simplicity of the idea belies the complications that have developed in implementation. Regulation J and the Fed's operating circulars now require a payor bank that decides to dishonor a check for \$2500 or more to provide notification of nonpayment to the presenting institution, usually the Fed. The Fed then initiates notification to the institution that sent the check for collection through the Fed. This procedure has given rise to several major difficulties. Because no sanction was imposed for failure to comply with this requirement, many institutions simply ignored it.¹²⁴ There is no requirement that the payor institution notify the depository directly. Further, there is no time limit for providing notification. This ambiguity has, in some cases, resulted in the returned check arriving at the depository at the same time as, or before, notification.¹²⁵

Despite the Federal Reserve's long experience with a wire advice requirement, several basic questions about fulfilling the requirement remain unresolved: who must give the advice of dishonor; to whom must the wire advice be given; and what sanctions should be applied for failure to give the advice in time for the depository bank to act on the early notification?

The U.C.C. only requires payor banks to return the item¹²⁶ or to

122. See Mulford, *supra* note 117, at 624.

123. See Regulation J, 12 C.F.R. § 210 (1984); Federal Reserve Bank of San Francisco, Circular 1 (Aug. 1, 1981); Pilot Project of the Joint American Bankers Association/Federal Reserve System Coordinating Committee in Columbus, Ohio (March 1976) (minutes of conference of first vice presidents of the Federal Reserve Banks (April 29-30, 1975)) [hereinafter cited as Pilot Project]; see also Mulford, *supra* note 117. The Fair Deposit Availability Act of 1983, S. 573, 98th Cong., 1st Sess., § 6 (1983), requires the payor to send direct notification to the depository within 24 hours after dishonor for checks of \$250 or more.

124. Amendments to Regulation J, 50 Fed. Reg. 5734, 5735 (1985) (supplementary information).

125. *Id.*

126. Mulford, *supra* note 117, at 624.

send *written* notice of dishonor before the midnight deadline.¹²⁷ If the payor fails to do one or the other, it will be strictly liable for the face amount of the item.¹²⁸ In contrast, the failure of the collecting banks to return the item or give notice of its dishonor may create liability for negligence under section 4-202.¹²⁹ Collecting banks are held to a standard of ordinary care in giving notice, which can be either written or oral.¹³⁰

The Federal Reserve's Regulation J is the exclusive basis for the argument that a bank has a duty to send telephone notice of return.¹³¹ The courts interpreting this regulation, however, have refrained from holding banks strictly liable for violations of the standard set by the Federal Reserve wire advice requirements. Instead, they have held that the Federal Reserve wire advice rules make no explicit reference to a sanction for failure to comply.¹³² Unlike the U.C.C. provisions, the wire advice rules in Regulation J do not distinguish between the obligations of payor and collecting banks. Thus, interpreting the Regulation to contain an implied requirement of accountability would expose collecting banks to a dramatic increase in the standard for liability over the negligence standard now imposed by the U.C.C. Courts have been reluctant to impose such a harsh result.¹³³

127. U.C.C. § 4-301(1) (1978) states:

[T]he payor bank may revoke the settlement and recover any payment if before it has made final payment . . . and before its midnight deadline it

(a) returns the item; or

(b) sends written notice of dishonor or nonpayment if the item is held for protest or is otherwise unavailable for return.

128. *Id.* § 4-302 states that "a payor bank . . . is accountable for the amount of . . . a demand item . . . if the bank . . . does not pay or return the item or send notice of dishonor until after its midnight deadline."

129. *See, e.g., Whalen & Sons Grain Co. v. Missouri Delta Bank*, 496 F. Supp. 211, 29 U.C.C. Rep. Serv. (Callaghan) 1574 (E.D. Mo. 1980). The court held that when the item had been returned, the payor bank was under the same standard with regard to notice as the collecting bank. This standard simply required that the bank exercise due care, unlike the strict liability standard of § 4-302. The bank could then seek to limit the damages available for breach to those that could be causally connected to the failure to give notice. The depository would be required to show that but for the failure to give notice, the item would have been collected.

130. U.C.C. § 4-202(1)(b) (1978).

131. Regulation J, 12 C.F.R. § 210 (1984), sets the standard of care for banks which send items through the Fed. In general, compliance with the terms of Regulation J will be sufficient to meet the standards for check collection stated in article 4. *See supra* note 52.

132. *See supra* note 129.

133. One particularly well reasoned opinion reflects the general view of this issue. *See Colorado Nat'l Bank v. First Nat'l Bank & Trust Co.*, 459 F. Supp. 1366, 1372 (W.D. Mich. 1978); *accord Bank of Wyandotte v. Woodrow*, 394 F. Supp. 550, 557 (W.D. Mo. 1975). This view has been wrongly held to extend to checks which were not collected through the Federal Reserve system. *See Wells Fargo Bank v. Hartford Nat'l Bank & Trust Co.*, 484 F. Supp. 817 (D. Conn. 1980).

In addition to failing to specify the liability for its violations, the current Fed wire advice requirement does not indicate *when* the notice must be sent. Instead, the courts considering the question have simply assumed that the U.C.C.'s midnight deadline is the relevant time limit. Nor does the rule state *to whom* the notice should be sent; here again, the courts turn to the U.C.C. to fill in the gaps. Under the U.C.C. the payor may return the item directly to the depository¹³⁴ or to the next prior endorser, as noted above. Unfortunately most banks have chosen the latter option.¹³⁵ Similarly, the practice for wire advice is to send the advice to the next prior endorser. This practice poses essentially the same problems presented by returning the item through the forwarding institutions.

The problems described above have prompted a number of experiments and studies, all of which have met with little success.¹³⁶ Today, the wire advice option is considered to be an unattractive business cost. The payor bank must absorb the cost of increased telephone bills and clerical expense without any tangible legal or competitive benefit. In one Federal Reserve experiment, payor banks gave notice for only fifty percent of the eligible items.¹³⁷

Moreover, banks may encounter substantial peril even when they give wire notice of return, as illustrated in *Lufthansa German Airlines v. Bank of America*.¹³⁸ The depository bank's right to exercise a valid chargeback was challenged when it received an inadequate notice from the Federal Reserve Bank. The payee of a check for \$63,081, drawn on the account of a company about to enter bankruptcy, deposited the check in its account with Bank of America. The check was subsequently dishonored because of insufficient funds. The Federal Reserve notified the Bank of America of the dishonor by placing a telephone call to the bank's Centralized Returned Items Section.¹³⁹ The call relayed the

134. U.C.C. § 4-212 (1978).

135. See *supra* notes 86-90 & accompanying text. There is some indication that direct returns have increased since 1981 when the Fed began implementation of its pricing policies. This increase reflects a choice by some institutions to avoid the new Fed pricing structure by taking advantage of cheaper alternatives, including direct return. See Frodin, *supra* note 36, at 17.

136. See, e.g., Pilot Project, *supra* note 123; RETURN ITEM TASKFORCE REPORT, *supra* note 2, at 1-2; see also Mulford, The Federal Reserve's "Wire Advice of Nonpayment": What It Is, What It Should Be, Apr. 1982, at 15 (unpublished portion of Mulford, *supra* note 117) (copy on file with the *Hastings Law Journal*).

137. See Mulford, *supra* note 117, at 631.

138. 652 F.2d 835 (9th Cir. 1981).

139. The court viewed the returned item section as a separate branch because it provided only the sorting and routing service for the branches. The court thus distinguished *Farmers & Merchants Bank v. Bank of Am.*, 20 Cal. App. 3d 939, 98 Cal. Rptr. 381 (1971), in which the

amount of the dishonored check, the reason for the dishonor, the date of the Federal Reserve cash letter, the name of the maker, and the routing number for Bank of America. The notification did not include the routing symbol for the branch on which the check was drawn. In fact, only one routing symbol was assigned to the entire Bank of America branch network. In addition, the relevant Fed operating circular did not require that the branch or the identity of the customer be included in the notification.¹⁴⁰ Thus, the bank was unable to identify either the payee or the branch in which the account was held until the item itself was returned, well beyond the midnight deadline.

The court refused to penalize Bank of America for the delayed notice and chargeback to its customer, holding that the late chargeback was not a voidable preference under bankruptcy law.¹⁴¹ The court applied section 4-212(1), which grants a depository bank seeking to exercise its right to a chargeback a "longer reasonable time" after its midnight deadline if it has not received by then facts sufficient to provide a basis for action, and reasoned that the right to chargeback did not terminate until enough information had been received to permit the bank to act.¹⁴²

Thus, after *Lufthansa* banks subject to Regulation J not only must give timely wire notice of return, but also must give enough information to permit the recipient to act. This requirement presents a problem for banks using Federal Reserve clearing facilities, because the Fed system limits banks with branch networks to a single symbol. The *Lufthansa* problem, therefore, will be inevitable in many instances. Moreover, the court refused to impose on the recipient of the notice an affirmative duty to inquire.¹⁴³

The *Lufthansa* problem will be avoided for items over \$2500 by the new amendments to the Fed wire advice rules requiring that enough information be given to permit action on the item.¹⁴⁴ The 1985 amend-

court held that when the bank processing center performed bookkeeping functions which were previously performed by a branch, the entities must be treated as one under CAL. COM. CODE § 4106 (West 1964). If, however, the branch consisted only of facilities for sorting items for distribution to branches, the bank and the center were to be viewed as separate entities. *Lufthansa*, 652 F.2d at 836.

140. *Lufthansa*, 652 F.2d at 836.

141. *Id.*

142. *Id.*

143. *Id.*

144. Amendments to Regulation J, 50 Fed. Reg. 5734 (1985) (to be codified at 12 C.F.R. § 210).

The information contained in the notice shall include the name of the paying bank, the name of the payee, the amount of the item, the reason for return, the date of the indorsement of the depository bank, the account number of the depositor, *the branch*

ments require notice of nonpayment directly to the institution of first deposit.¹⁴⁵ The payor bank will be able to choose whether to provide the required notice by placing a telephone call or by sending the item itself. The Fed will enhance its current notification service by providing access for notice on items collected outside the Federal Reserve.¹⁴⁶

A Question of Business Judgment

Given the amorphous system for return item processing, the decision to permit a depositor to withdraw funds is largely a business risk calculation.¹⁴⁷ The discretion inherent in such decisions suggests that the industry custom or the individual banker's judgment in this matter should be treated with deference on review. In this section, however, the Article demonstrates that these business judgments can be reviewed without undue interference with the banking industry's necessary assessment of risk on the basis of sound and objective banking experience.

One controversial banking industry practice is to authorize blanket holds for all depositors without taking into account individual risk factors.¹⁴⁸ Yet, in determining a hold policy, there are two primary areas in

at which the item was first deposited, and the trace number on the item of the depository bank, and should otherwise be in accordance with uniform standards and procedures specified by the operating circular of the paying bank's Reserve Bank. A paying bank is not required to provide any information in the notice that it, after exercising ordinary care and acting in good faith, is not able to determine with reasonable certainty from the item itself.

Id. at 5740 (emphasis added). These amendments incorporate the *Lufthansa* result for items over \$2500 which are collected through the Fed.

145. See Amendments to Regulation J, 50 Fed. Reg. 5734 (1985) (to be codified at 12 C.F.R. § 210). This amendment is designed to reduce uncertainty concerning the fate of large dollar items processed through the Fed by requiring, effective Oct. 1, 1985, that payor banks give notice of dishonor to the depository for cash items in the amount of \$2500 or more. Notice is required to be sent by "midnight of the second banking day . . . following the deadline for return of the item specified in paragraph a [of Regulation J]." *Id.* at 5735.

146. The fees for the enhanced notification service range from \$2.25 per advice for an on-line Fed Wire message to \$4.25 per advice for telephoned requests to forward notice to the depository. Letter from Richard T. Griffith, First Vice President, Federal Reserve Bank of San Francisco, to Depository Institutions of the Twelfth Federal Reserve District (Feb. 21, 1985).

147. "Although the risk of loss to depository institutions associated with returned items is relatively small in the aggregate, many institutions point to the potential losses they could incur on returned checks as the reason for their delayed availability policies." Amendments to Regulation J, 50 Fed. Reg. 5734, 5734-35 (1985) (to be codified at 12 C.F.R. § 210).

148. See Policy Statement, *supra* note 92.

Regrettably, the banking industry has tended to design hold policies to enhance the profitability of accounts. One commentator has noted that "retail banking is not highly profitable; working off the float helps recoup costs. Without profits from the float, the banks might have to increase charges or eliminate services." Saltzman, *The Floating Check Game*, *FORBES*, Mar. 5, 1979, at 135-36. When banks make hold policies an integral part of pricing, without letting customers know the cost of such hold practices, the result is in effect a misrepresenta-

which the actual experience of each financial institution appropriately can be taken into account: the depositor's creditworthiness and the probability of criminal check kiting or fraud.

When a financial institution decides to permit its customer to withdraw against funds that are in the process of collection, the bank may consider several factors relevant to the debtor's creditworthiness. The bank may consider the length of time the account has been active, the number and frequency of insufficient funds returns, the existence of overdraft protection, and the average daily balance in the account.¹⁴⁹ In addition, the bank is entitled to scrutinize the item itself to determine whether there are any obvious signs that it may be returned.¹⁵⁰ For instance, the impending insolvency of the drawer may be public knowledge or known to the bank through other channels. Thus, an *objective* basis for doubting the collectability of the item would be sufficient to justify a reasonable hold to ensure that the item clears.¹⁵¹ In addition, new account holders are a particularly problematic group of depositors.¹⁵² Thus, evaluation of the duration of the account relationship would certainly be one of the factors which may be considered. Finally, large value checks are likely to receive close scrutiny because while the

tion. Some within the industry have supported blanket holds based upon a pricing strategy rationale. See Position Paper, *supra* note 2, at 5, where it was noted that: "[A]vailability polices [sic] can be implemented as part of the pricing strategy of the bank in order to maintain investable collected balances, while minimizing direct costs to the consumer for checking account services. When used in this manner, the length of the availability hold would be based as much on required balances as on collection time." This explicit and disturbing effort to justify blanket holds provides clear evidence of the need for objective guidelines.

149. See Amendments to Regulation J, 50 Fed. Reg. 5734-35 (1985) (to be codified at 12 C.F.R. § 210).

150. One recent case involving MICR encoding fraud, *United States Fidelity and Guaranty Co. v. Federal Reserve Bank*, 590 F. Supp. 486 (S.D.N.Y. 1984), has caused consternation within the financial services community. A depositor defrauded Union Trust Bank by depositing a check with a MICR number that did not match the routing symbol. The MICR number is printed in magnetic ink along the bottom of the check and allows a machine at each bank automatically to route the check to its next destination. This number ordinarily is the same as the printed number in the upper right hand corner of the check. *Id.* at 490.

As a result of the depositor's fraud, the check was routed through five banks in approximately two weeks. Because 10 days had expired without notification that the check would not be paid, the depository bank permitted the depositor to draw \$755,000 against the check. Union Bank sued the New York Fed for breach of its U.C.C.-imposed duty to use ordinary care in sending notice of dishonor or non-payment. *Id.* at 491. The district court denied the Fed's motion to dismiss, holding that the Fed may be held liable if a bank exercising ordinary care in the standard processing of returned checks would have recognized the defect in the check. *Id.* at 499, 501.

151. See Amendments to Regulation J, 50 Fed. Reg. 5734-35 (1985) (to be codified at 12 C.F.R. § 210).

152. There is commonly accepted anecdotal evidence that new accounts (accounts open for less than six months) are the highest risk group of depositors.

probability of loss is low, the extent of the loss, should it occur, would be substantial.¹⁵³

Check kiting and criminal fraud, which pose substantial risks to financial institutions and their depositors, raise more serious issues.¹⁵⁴ Check kiting is a crime that occurs when a depositor uses two bank accounts in distant locations to take advantage of the normal period of delay in processing and returning insufficient fund checks. An uncomplicated version of this pattern might involve depositing a worthless check drawn on a Boston account in a San Francisco bank. The San Francisco account in turn is used to draw a check that is then deposited in the Boston bank. The kiter may deposit several items in this way within a short period of time to give the appearance of substantial balances, when in fact both accounts may be empty or contain very small amounts. When one of the banks permits a withdrawal of cash, the kite has succeeded.¹⁵⁵

Although blanket hold policies have most often been justified as necessary to thwart criminal kitters, the argument does not withstand close scrutiny. Every bank has available basic security measures which enable it quickly to detect criminal activity within an account. Typically, a profile of variables that are reliable predictors of fraud are applied to screen suspected accounts.¹⁵⁶ Thus, banks have precision instruments available to handle the specialized problems of fraud; to resort to the blunt instrument of blanket holds is unnecessary to secure protection from fraud.¹⁵⁷

Moreover, the argument that the blanket hold policy is necessary to thwart check kitters is overbroad, as illustrated by the banks' practice of granting ad hoc exemptions from the policy. For example, a bank may often permit corporate and select individual depositors to negotiate im-

153. This may present problems for depositors who recently have sold a house and seek immediate access to the proceeds. Testimony from the California Association of Realtors before the California Senate Banking and Insurance Committee suggests that a substantial number of depositors fit this description. Bankers would prefer to use alternate means of confirming the availability of these funds. Wire transfer and telephone confirmation of balances are among the options discussed below. *But see* Amendments to Regulation J, 50 Fed. Reg. 5734 (1985) (to be codified at 12 C.F.R. § 210). This recent amendment provides notice within a specified period when checks over \$2500 are being returned. This appears to be an effective way of reducing the risk of large checks to the institution of first deposit. *See supra* notes 144-46 & accompanying text.

154. *See* RETURN ITEM TASKFORCE REPORT, *supra* note 2, at 7.

155. An extended discussion of check kiting is beyond the scope of this Article. Check kiting, however, bears on the issue of float because bankers have cited the risk of fraud as one of the principal justifications for blanket holds. *See also* W. GIBSON, *THE FINE ART OF SWINDLING* (1966); M. MCGUIRE, *THE FORGERS* (1969).

156. *See* B. CLARK, *supra* note 31, § 4.12, S4-18 to -20 (Cum. Supp. 1983).

157. *See generally* *Delayed Funds Availability Hearing*, *supra* note 5.

mediate availability,¹⁵⁸ while more timid and less influential depositors languish under blanket holds. It has also become standard operating procedure to grant liberal waivers and exemptions from the hold policies to customers who complain.¹⁵⁹

A policy of giving ad hoc waivers has been held, in at least one case, to have no effect on the bank's right subsequently to refuse withdrawal before final payment has been confirmed, even if earlier waivers had been given to the same customer.¹⁶⁰ The effect of such arbitrary and often purely subjective decisionmaking is to raise the level of consumer complaint and to tarnish the banking industry's image of objectivity and fairness. In fact, the growing perception of arbitrariness has provided the fuel for a consumer-led fight against the banks over float.¹⁶¹

A Matter of Litigation

To date no lawsuit has successfully challenged a blanket hold pol-

158. See *supra* note 98 & accompanying text. Assuming the good faith of corporate depositors, however, can be perilous, as illustrated by the recent E.F. Hutton indictment on 2000 counts of check kiting fraud involving \$10 billion worth of checks. Wall St. J., May 6, 1985, at 3, col. 2.

159. See *Delayed Funds Availability Hearing*, *supra* note 5, at 24.

160. *Id.*; see also, e.g., *Discount Auto Mart, Inc. v. Bank of North Carolina*, 45 N.C. App. 543, 263 S.E.2d 41 (1980). In *Discount Auto Mart* the court held that a bank is entitled to choose whether to stand on or waive its right each time the depositor attempts to withdraw against uncollected funds. *Id.* at 544, 263 S.E.2d at 42. The bank had permitted the customer to make withdrawals against uncollected funds over a 15-month period of time. The court upheld the bank's subsequent refusal to honor items drawn in this manner. *Id.*

161. The hold policies that are the subject of this Article have become increasingly frequent topics in the popular press. See, e.g., Ballen, *There Are No Easy Solutions to the Delayed-Availability Problem*, NAT'L L.J., Aug. 13, 1984, at 15-19; Cooper, *The Banker's Float That Sinks Depositors*, 43 BUS. & SOC. REV. 42 (1982), reprinted from THE NATION, June 5, 1982, at 682; Ross, *supra* note 39, at 75; Saltzman, *supra* note 148, at 135; *That #1% Float*, TIME, May 16, 1983, at 59; Kasabian, *Much Diluted Check Float Reforms Ready*, San Francisco Examiner, July 1, 1984, at D1, col. 1; Williams, *Banks' Slowness in Clearing Checks Prompts State and Federal Actions*, Wall St. J., Mar. 6, 1984, at 2, col. 4; *Fed Wants to Cut Time Banks Hold Checks*, San Francisco Chron., Feb. 16, 1984, at 31, col. 5; Bonner, *U.S. Rule on Bank Fees Draws Fire*, N.Y. Times, Dec. 19, 1983, at D1, col. 3; Mandel, *Compromise Bill to Limit Bank Float Looks Like a Winner*, San Francisco Examiner, Aug. 18, 1983, at A3, col. 1; Schares, *Banks Gain as State Eases Check Rules*, San Francisco Examiner, June 14, 1983, at 33, col. 1; Cooke, *Bankers' Float Gets Deflated by Assembly Panel*, San Francisco Examiner, May 19, 1983, at B1, col. 1; Schares, *Regulators Near a Decision to Cut Back on "Bank Float"*, San Francisco Examiner, May 16, 1974, at 25, col. 1; Schares, *The Dispute Over Bank "Float"*, Peninsula Times-Tribune, Apr. 24, 1983, at D1, col. 2; Chira, *Albany Agrees on Bills to Aid Consumers*, N.Y. Times, Mar. 24, 1983, at B1, col. 6; Mandel, *The 1 Percent Solution*, San Francisco Examiner, Feb. 20, 1983, at A2, col. 1; Kasabian, *Banker's Warning if Float Bill Passes*, San Francisco Examiner, July 24, 1983, at D1, col. 1; Mandel, *It's Time to Stop Bank Float*, San Francisco Sunday Examiner and Chron., Jan. 30, 1983, at A2, col. 1; Bettner, *Banks Still Placing Lengthy Holds on Checks Despite Quick Clearing*, Wall St. J., Jan. 12, 1983, at 31, col. 4.

icy.¹⁶² The most renowned case in which the issue was squarely raised is *Rapp v. Dime Savings Bank*.¹⁶³ In *Rapp*, the depositor sought a declaratory judgment against the Dime Savings Bank to end the thrift bank's time restrictions on the availability of deposits. The plaintiff also alleged that the advertising of "free checking accounts" without also advertising the hold policy was false advertising and fraudulent concealment. In the plaintiff's view, the policy of restricting access to local checks for six days and to nonlocal checks for fifteen days violated U.C.C. section 4-204(1), which requires that a collecting bank send items by a "reasonably prompt" method.¹⁶⁴ Plaintiff also argued that the time restrictions were

162. There have been at least two settlements and one proposed settlement involving hold policies. In *Chadwick v. Crocker Nat'l Bank*, Civ. No. 792521 (San Francisco Super. Ct. Dec. 22, 1983), the plaintiffs sought declaratory, injunctive, and restitutionary relief. They claimed that the bank placed unreasonably long holds on checks deposited in checking and savings accounts, and that this hold policy was not adequately disclosed to depositors.

The settlement provided that the bank would not hold most checks under \$1000. The hold period for out-of-state items was reduced from 15 days to 10-12 days. This period was still longer than that ultimately required through regulations which became effective less than a year later. See Table *infra* text accompanying note 197. The settlement also provided for a telephone verification procedure by which depositors could have the bank verify the funds directly with the payor bank. The parties anticipated that telephone verification would permit funds to be released in as few as three business days.

A settlement also was reached in *Ricketts v. Lloyds Bank of California*, No. 343769 (L.A. Super. Ct., May 13, 1983). That settlement provided for a one-day reduction in holds and disclosure of the hold policy.

In addition to *Chadwick* and *Ricketts*, a controversial settlement has been proposed in a recent case, *California Consumers Assoc. v. Independence Bank*, CA-000-823 (L.A. Super. Ct. 1985), a class action challenging the hold policies of 421 California banks. The settlement proposes to impose a "fine" of \$7500 for each member of the defendant class who wishes to obtain the res judicata protection from the settlement. Those banks which refuse to pay the specified amount would be subject to further litigation and possible antitrust actions.

The proposed settlement has generated substantial controversy. See Luke, *California Banks in Quandary Over Suit on Check-Hold Policy*, AM. BANKER, Nov. 26, 1984, at 1; *Questions Raised Over Settlement in Suit Against Banks: Motives Challenged*, L.A. Daily J., Dec. 14, 1984, at 1, col. 1. Objections have been filed by the west coast office of Consumers Union, see Letter from Carl Oshiro to the Honorable Norman Dowds (December 11, 1984) (discussing, as amicus curiae, the basis for Consumers Union's opposition to the settlement) (copy on file with the *Hastings Law Journal*), and the California Department of Justice, see Letter from Ronald Reiter to the Honorable Norman Dowds (November 15, 1984) (discussing the Attorney General's serious concerns about the proposed settlement) (copy on file with the *Hastings Law Journal*). The objections are based on concern for the absence of equitable or monetary relief for members of the class and an alleged conflict of interest for the sole attorney for the class, who proposed that one-third of the settlement be committed to attorney fees.

163. 408 N.Y.S.2d 540 (App. Div. 1978), *aff'd*, 48 N.Y.2d 658, 396 N.E.2d 740 (1979).

164. U.C.C. § 4-204(1) (1978) provides: "A collecting bank must send items by reasonably prompt method taking into consideration any relevant instructions, the nature of the item, the number of such items on hand, and the cost of collection involved and the method generally used by it or others to present such items."

a violation of section 4-213(4)(a),¹⁶⁵ which gives customers the right to withdraw funds when the bank has received a provisional settlement for the item, the settlement has become final, and "the bank has had a reasonable time to learn that the settlement is final." The court rejected the argument under section 4-204, concluding that the section did not apply to the question of hold policies because the scope of the section was confined to the "general standards applicable to proper sending or forwarding of items."¹⁶⁶ Thus, the court deemed the time restrictions "relevant only insofar as they require the Dime to promptly forward checks to clearance."¹⁶⁷

In *Rapp*, the court apparently concluded that any delay in presentment resulted because Dime is a thrift bank,¹⁶⁸ which is not permitted to clear checks directly through the Fed. Thrift banks must use the clearing facilities of commercial banks, which then clear them through the Fed.¹⁶⁹ The use of intermediate handling, even for local checks, was acceptable because it was the custom for "savings banks." Therefore, even if slow presentment were an issue in *Rapp*, the slowness could not be considered to be outside the "general banking usage."¹⁷⁰

The plaintiff's arguments that the bank's practice violated the U.C.C. were also defeated by the application of U.C.C. section 4-103(1). This section allows parties to a transaction to vary the explicit terms of the U.C.C. by agreement, except that

no agreement can disclaim a bank's responsibility for its own lack of good faith or failure to exercise ordinary care or can limit the measure of damages for such lack or failure; but the parties may *by agreement determine the standards by which such responsibility is to be measured if such standards are not manifestly unreasonable*.¹⁷¹

The court concluded that this section allowed the parties to define reasonableness by agreement.¹⁷² The irony is that the application of section 4-103 is made possible by the operation of section 1-201(3), which permits bank customers to be bound by an industry practice without assent or bargain.¹⁷³ In *Rapp*, the back of the deposit slip contained a "collec-

165. See *supra* note 11.

166. *Rapp*, 408 N.Y.S.2d at 544 (quoting U.C.C. § 4-204 comment 1 (1978)).

167. *Id.*

168. *Id.* at 543.

169. *Id.*

170. *Id.* This same rationale seemed to apply to § 4-213(4)(a), although the court avoided a direct holding on plaintiff's entitlement to go forward under either § 4-204 or § 4-213.

171. U.C.C. § 4-103(1) (1978) (emphasis added).

172. *Rapp*, 408 N.Y.S.2d at 545.

173. Section 1-201(3) provides: "'Agreement' means the bargain of the parties in fact as found in their language or by implication from other circumstances including *course of dealing*

tion agreement" which stated that the "proceeds of a deposit consisting of checks is not available until 6 business days clearance time has elapsed for a local check and/or 15 business days on all other checks." The same notice was posted in each branch office.¹⁷⁴ The court concluded that banking usage and the specific "agreement" were sufficient to establish the reasonableness of the practice of six-day holds for checks drawn on New York City banks. Moreover, the court concluded that the practices of thrift banks could not be measured by the standard of the commercial banks and refused to compare these longer times to the faster clearing and return times for commercial banks.¹⁷⁵ Instead, the court found that the evidence that other thrifts had a similarly aggressive hold policy "conclusively establishes that the Dime's time restrictions are fully in accord with general banking usage and therefore comport with the exercise of ordinary care."¹⁷⁶ On that basis, defendant was granted a summary judgment. Thus, section 4-103(1), which was so controversial at the time of its adoption,¹⁷⁷ became the vehicle for insuring that hold

or usage of trade or course of performance" U.C.C. § 1-201(3) (1978) (emphasis added). This definition expands the term "agreement" substantially beyond its common law meaning.

174. *Rapp*, 408 N.Y.S.2d at 545.

175. The plaintiffs introduced evidence tending to show that commercial banks impose restrictions on withdrawal for three business days for local checks and five to ten days for nonlocal checks. *Id.* at 546.

176. *Id.*

177. During the debate preceding the adoption of the U.C.C., Professor Fred Beutel, of the University of Minnesota, objected to the aggressive, bank-oriented risk allocation of the new code. He noted that article 4 subjected depositors to new risks of collection and that banks were permitted to contract out of every important risk except their basic duty of care. Beutel, *The Proposed Uniform [?] Commercial Code Should Not be Adopted*, 61 YALE L.J. 334, 357-63 (1952). He concluded that article 4 "was drafted entirely with the purpose of protecting the banks so that they could carry on their business at the risk of the customer." *Id.* at 361. *But see* Gilmore, *The Uniform Commercial Code: A Reply to Professor Beutel*, 61 YALE L.J. 364 (1952).

Professor Beutel singled out § 4-103 for especially caustic criticism. As he explained: The bank may also change by contract any of the rules set out in this act except the duty of due care. Thus the "Code" appears to completely approve the type of surreptitious waivers consistently appearing in fine print on bank forms, in spite of the fact that many courts have refused to enforce "contracts" of this kind. Article 4 and the definitions of contracts found in the "Code" give them blanket approval. Beutel, *supra*, at 361.

Even Professor Grant Gilmore had strong objections to the adoption of § 4-103:

The feature of Article 4 as it appears in the final version of the Code which is enough to make the entire Article objectionable is the freedom of contract section, § 4-103. This Section as drafted provides that banks may by general or special agreement contract out of any of the rules laid down in the balance of the Article, provided only that a bank may not disclaim responsibility for the exercise of good faith and ordinary care. The proviso is, however, subject to a double-barrelled exception: 1) banks may agree on what constitutes ordinary care; 2) even in the absence of agreement, any action taken by a bank which is consistent with "a banking usage" is

practices would become immune from judicial review.¹⁷⁸

The outcome in *Rapp* is not surprising. In effect, once section 4-103 (1) is applied, any industry practice which is not *manifestly unreasonable* not only will survive challenge, but also may support a summary judgment as in *Rapp*. In general, litigation is an ineffective approach to the delayed availability problem. The problem is a national one involving the entire check collection system. At best, litigation is an expensive way to correct a symptom of the problem—a bank's hold policy. No lawsuit can cure the disease of slow return item processing. The result in *Rapp* illustrates the need for legislation that overrides section 4-103(1) by setting a standard of reasonableness which cannot be varied by agreement.

Legislative Solutions

Reforming the law regarding return item processing and delayed availability is a formidable challenge. Any sound legislative solution must address the following problem areas: First, the customer's need to know, before an account is opened and periodically after it is opened, the general hold policy of the institution;¹⁷⁹ second, the customer's need to be informed of the bank's decision to place a hold on any specific item; third, the need to set maximum hold periods to draw a bright line for those institutions seeking to stretch the hold beyond what is reasonably

ordinary care. It should be noted further that the "general agreements" by which banks may amend the Article as they see fit, or agree on what ordinary care is, *are agreements between banks to which the customer who deposits an item for collection is not a party but by which he will be bound*.

This is carrying a good joke too far. The only bright spots are: . . . that *Section 4-103 contains more than one loophole in the drafting on which a court might well seize to limit the scope of "variation by agreement"* which the Section was designed to permit.

. . . *I have not been convinced that it can ever be sound legislative policy to write a blank check to the order of any private interest group in the community.*

. . . But there are bad times as well as good times; there may even be bad banks as well as good banks. Section 4-103 goes far beyond what is wise or permissible in allowing banks to rewrite the law their way whenever things get tough.

Gilmore, *supra*, at 375-77 (emphasis added).

178. While the analysis in *Rapp* is largely unsatisfying, the most obvious flaw is the court's readiness to concede the enforceability in contract law of the preprinted statement of hold policy. Even if one accepts the conclusion that Dime's hold policy is a term of a bargain transaction that was "ratified each time the plaintiffs voluntarily deposited checks into their account," 408 N.Y.S.2d at 545, it does not follow that it was an equal bargain. This case seemed appropriate for an adhesion contract analysis. Cf. *Graham v. Scissor-Tail, Inc.*, 28 Cal.3d 807, 623 P.2d 165, 171 Cal. Rptr. 604 (1981); *A & M Produce Co. v. FMC Corp.*, 132 Cal. App. 3d 473, 186 Cal. Rptr. 114 (1982); *Neal v. State Farm Ins. Cos.*, 188 Cal. App. 2d 690, 10 Cal. Rptr. 781 (1961).

179. See Policy Statement, *supra* note 92, at 5.

necessary; fourth, the need to restrict the opportunity, under section 4-103,¹⁸⁰ to vary the new law by agreement; fifth, the central problem of the methods and routes chosen for handling return items; sixth, ownership of the interest that accrues even during legitimate hold periods; and seventh, an appropriate penalty for willful violators.¹⁸¹

Disclosure and Notification

Disclosure and notification are the least controversial proposals for reform.¹⁸² Although closely related, the ideas of disclosure and notification serve different functions. Disclosure is intended to permit bank customers to know what the hold policy is before an account relationship is formed. To avoid the surprise that occurs when hold policies have not been clearly disclosed, an accurate description of the policy is essential. A disclosure requirement would permit the competitive forces in the financial services industry to work to the depositor's advantage. Depositors would have an opportunity to examine this policy, along with the full range of banking services, when electing the banks with which they do business.¹⁸³

As uncontroversial as disclosure might be, however, the question remains what should be disclosed and when.¹⁸⁴ A basic objective of this kind of legislation is to eliminate the element of surprise awaiting depositors who are unaware of the hold policy in general and of the application of that policy to a specific transaction. Thus, a model disclosure should include a general description of the typical hold periods for out-of-state, intra-state, and local checks.¹⁸⁵ An appropriate notice identifying the

180. See *supra* notes 171-72, 177 & accompanying text.

181. See *infra* note 223.

182. Every major discussion of the problem of delayed funds availability has endorsed the idea of disclosure. See, e.g., Policy Statement, *supra* note 92; AMERICAN BANKERS ASSOCIATION, FINAL REPORT AND RECOMMENDATIONS OF THE DELAYED FUNDS AVAILABILITY TASK FORCE, reprinted in *Delayed Funds Availability Hearing*, *supra* note 5, at 131; RETURN ITEM TASKFORCE REPORT, *supra* note 2, at 6; see also S. 573, 98th Cong., 1st Sess. (1983); H.R. 5301, 98th Cong., 2d Sess. (1984).

183. Consumers Union has advised its readers to "shop around for the bank in your area that has the shortest holding periods. We suggest getting the information in writing. CU callers have gotten conflicting information on successive calls to the same bank." *When Is It Your Money*, 49 CONSUMER REPORTS 648, 649 (Nov. 1984).

184. Disclosure practices vary considerably. Among the smallest community banks (those with less than \$50 million in assets), 80% use teller notice to communicate hold policies, 55% give notice when the account is opened. Seventy-five percent of institutions with assets over \$1 billion give written notice when the account is opened and 47% give teller notice. 1984 DEPOSIT SERVICES REPORT, *supra* note 2, at 8, 9, 42.

185. Members of the ABA Delayed Availability Task Force prepared sample forms which were submitted for the record during the Senate hearings on S. 573. *Delayed Funds Availability Hearing*, *supra* note 5, at 151-53.

item that will be subject to the hold and the length of the hold should be sent to each depositor.¹⁸⁶ The recently enacted California Delayed Availability Law¹⁸⁷ provides a good, though not perfect, model for identifying the strengths and shortcomings of legislative solutions to the hold policy problem.¹⁸⁸ For example, in California the question arose as to whether disclosure requirements were applicable to automated teller transactions. Banks had expressed concern about the space available to accommodate an individual statement of hold policy. The statute requires that the deposit envelope bear the required disclosure.¹⁸⁹ The tim-

186. See CAL. FIN. CODE § 866.2(b) (West Supp. 1985).

187. Act of Sept. 21, 1983, ch. 1011, 1983 Cal. Legis. Serv. 5388 (West) (amending CAL. COM. CODE §§ 4212, 4213 and supplementing CAL. FIN. CODE §§ 866.5, 866.6, 866.7, 866.9).

188. Delayed funds availability reform is a politically volatile matter, as was demonstrated by both the New York and California experiences. In New York, reforms were adopted after years of unsuccessful effort. See N.Y. BANKING LAW § 14-d (McKinney Supp. 1984-1985). Some legislators suggested that the delayed availability reform was approved in exchange for passage of a bill that permitted banks to continue to charge 25% interest on consumer loans. N.Y. Times, March 24, 1983 at 44, col. 1; see also Letter from Bernard Karol, Assistant Counsel, New York Banking Department to author, April 20, 1983 (copy on file with *Hastings Law Journal*).

The California delayed availability law, A.B. 1723, was also enacted in a politically charged context. The bill was introduced by the Speaker of the California Assembly, Willie L. Brown, Jr., after a columnist, Bill Mandel of the San Francisco Examiner, invited readers to write to the Speaker to "vote against float." Readers were asked to send a coupon with the message:

Mr. Speaker: I think it is wrong of banks doing business in California to keep money away from its legitimate owners. I support an amendment to the Uniform Commercial Code requiring banks to credit customers' accounts within five business days of deposit, unless the funds have not actually been collected.

Mandel, *It's Time to Stop Bank Float*, San Francisco Sunday Examiner & Chron., Jan. 30, 1983, at A2, col. 1. More than 8000 readers responded, some adding individual stories of unnecessarily long holds by banks in the state. See Final Statement of Reasons, *supra* note 7, at 38.

There are similar delayed availability laws, either already enacted or pending, in several other jurisdictions. See, e.g., MASS. GEN. LAWS ANN. ch. 167d, § 34 (West 1984); S. 2851, 98th Cong., 2d Sess. (1984); S. 573, 98th Cong., 1st Sess. (1983); H.R. 5301, 98th Cong., 2d Sess. (1984); H.R. 4187, 98th Cong., 1st Sess. (1983); H.R. 5360, 98th Cong., 2d Sess. (1984). Measures have also been introduced or adopted in Maryland, Florida, Hawaii, Iowa, and Kentucky. See Wall St. J., Mar. 6, 1984, at 37, col. 1.

189. It was decided that individual notice could be given to customers at automated tellers. Given the increasing reliance on automated deposit takers, this was an important place for notice to be prominently displayed. CAL. FIN. CODE § 866.2(b) (West Supp. 1985) requires that the institution "furnish its customers preprinted deposit slips, envelopes for automatic teller machine deposits or other individual notice bearing a conspicuous summary statement of its general policy with respect to when a customer may withdraw funds deposited by check or similar instrument into the customer's deposit account . . ."

The major problem of providing a formulaic notice which may never be read may still exist. Even worse, it may be read but never considered as the basis for decisionmaking. I have concluded that disclosure is certainly helpful, but that consumer publications which evaluate the basic information are even more important.

ing of disclosure is also important; experience with other consumer disclosure statutes¹⁹⁰ suggests that technical, perfunctory disclosure may have no meaningful impact on a consumer's level of knowledge about the transaction. Therefore, periodic, simplified reminders of the hold policy are in order to remind the customer that the holds are a part of the bank's basic deposit-taking policy.

Direct notification from the payor to the depository has intrinsic appeal. Notwithstanding the problems of telephone, wire, and cable communication media, recent developments in computer-linked communications hold great promise for the development of electronic bulletin boards dedicated to posting return item notices to each bank in the United States. The approach proposed here would permit the posting of coded and abbreviated messages, which could then be captured from the computer bulletin board by the depository bank in which the item originated. A bulletin board system of communication would have the advantage of permitting banks wishing to obtain this information to do so without the delay and personnel costs of telephone calls from one bank officer to another. If the bulletin board system were provided by the Fed, some further reduction in expense could be obtained by making use of the reduced rates available to users of a national wide area telephone service (WATS) line.

Mandatory Availability

Mandatory availability has been the most controversial feature of the proposed reforms. It has been suggested that published schedules for maximum hold times will simply aid criminal check kites,¹⁹¹ who will manipulate deposits to take advantage of the law. Check kiting is a significant problem, but nonavailability of funds is not an appropriate means of preventing it.¹⁹² Undisclosed hold schedules have not stopped

190. See Magnuson-Moss Warranty-Federal Trade Commission Improvement Act, 15 U.S.C. §§ 2301-2312 (1982) (disclosure of consumer product warranty terms and conditions); Truth in Lending Act, 15 U.S.C. §§ 1601-1693 (1982) (disclosure of loan rate and terms); see also Priest, *A Theory of the Consumer Product Warranty*, 90 YALE L.J. 1297 (1981); Whitford, *Comment on a Theory of the Consumer Product Warranty*, 90 YALE L.J. 1371 (1982).

191. See *supra* notes 154-57 & accompanying text.

192. See Pratt, *Bank Frauds: Their Detection and Prevention*, reprinted in *Delayed Funds Availability Hearing*, *supra* note 5, at 146. Kites have caused losses large enough to eliminate the capital structure of a bank. Some banks would have closed as a result of such losses but for the recovery permitted under bankers' blanket bonds.

Losses from fraud are covered by insurance. Therefore, the effect of more fraud, should it occur, would be to increase the cost of doing business by the amount of the additional insurance premium. This additional cost would necessarily be passed on to depositors. Thus, banks and their depositors have a common interest in minimizing losses from fraud.

kiters. Although kiting may become somewhat easier if availability is determined by law, the banks' unlimited discretion to hold funds places the burden on those least able to bear it, the vast number of consumers who write good checks. Ultimately, the detection and prevention of crime should be left to techniques that are specifically tailored to address that problem.

The advantage of definite hold periods is that depositors will know what to expect. Further, if maximum hold times are set based upon the actual experience for collection and return, the industry custom will be taken into account, with the result that hold periods will be realistic and efficient. Finally, definite hold times can be used to provide an important incentive for securing technological improvements in return item processing.

The California statute amends U.C.C. section 4-213(4)(a) to delegate to the appropriate state agency the power to establish a schedule of definite times that are determined to be reasonable. In determining what constitutes a reasonable period of time the following factors are required to be taken into account: "(a) the actual time for processing and transport between the depository and payor institutions, (b) the fastest air transport time between depository and payor . . . [and] (c) the most expeditious route and means for processing of returned items."¹⁹³ The effect of this approach is to convert the expectation that the industry will improve the design and technology applied to the system for return item processing into a yardstick for measuring current performance. Thus, if properly applied,¹⁹⁴ mandatory availability can serve to prod the industry into making necessary improvements in return item processing and notification.

Another advantage of definite hold periods is that certain kinds of items, such as government checks, can be treated categorically, providing

193. CAL. FIN. CODE § 866.6(a)-(c) (West Supp. 1985).

194. Delegating the authority to set a mandatory availability schedule to an administrative agency has the attraction of permitting more flexibility. For example, if there were a sudden technological breakthrough that dramatically improved collection and return times, regulations could be changed more quickly than a statute to take this into account. This assumes, of course, that the administrative process is faster and more flexible than the legislative process, which is not always true. Professor Fairfax Leary expressed concern that delegation might prove troublesome, depending on the "composition of the Board and of the political atmosphere." Letter from Fairfax Leary to author (Aug. 10, 1983) (copy on file with author); see CAL. ADMIN. CODE tit. 10, R. 10.190400. These regulations were the subject of substantial controversy and as a result were delayed in implementation. See Final Statement of Reasons, *supra* note 7.

for one-or two-day availability.¹⁹⁵ For these items, the reliability of the drawer or acceptor should override any concerns about the ultimate collectability of the item.¹⁹⁶

The following table summarizes the reasonable hold periods established by regulation in New York and California as well as the wide range of hold periods established in practice by California depository institutions.¹⁹⁷

Table: Summary and Comparison of Check Hold Regulations and Practices

I. State Regulations

	<u>If drawn on a local institution</u>	<u>If drawn on any other state institution</u>	<u>If drawn on an out-of-state office</u>
<u>New York State Banking Regulations; Deposits in —</u>			
● New York banks	2 days	3 days	6 days
● Savings institutions	3 days	4 days	8 days
<u>California Department of Banking Regulations (Deposits in Banks)</u>			
● Drawn on a bank	2 days	3 - 4 days	8 - 9 days
● Drawn on a savings institution	4 - 5 days	4 - 5 days	9 - 10 days
<u>California Savings & Loan Department Regulations (Deposits in S & L's)</u>			
● Drawn on any institution	4 days	4 days	10 days
<u>California Department of Corporations Regs. (Deposits in Credit Unions)</u>			
● Drawn on any institution	5 days	5 days	9 days

195. CAL. ADMIN. CODE tit. 10, R. 10.190406(a)(1),(2) (West Supp. 1984); *see also* NEW YORK, GENERAL REGULATIONS OF THE BANKING BOARD, PART 34 (1983).

196. *See* Policy Statement, *supra* note 92, at 3.

197. The table is taken from CALIFORNIA DEPT. OF CONSUMER AFFAIRS, REPORT ON THE NEW FUNDS AVAILABILITY RULES FOR THE DEPOSIT OF CHECKS IN CALIFORNIA 66 (1985).

"Days" refers to business days. Both the New York and California regulations prescribe a ceiling of one day on holds placed on checks drawn on the same institution. The table does not reflect special exceptions contained in both states' regulations. *Id.*

II. Survey Data

San Francisco Consumer Action Survey Data; Deposits in —

● California banks	2 - 7 days	2 - 14 days	4 - 15 days
● Savings institutions	3 - 12 days	5 - 20 days	10 - 30 days

California Public Interest Research Group Survey Data; Deposits in —

● California banks	1 - 7 days	1 - 10 days	5 - 15 days
● Savings institutions	2 - 10 days	4 - 14 days	5 - 20 days
● Credit Unions	5 - 10 days	5 - 11 days	5 - 14 days

Finally, there is at least one important proposal which adopts a dramatically different approach to the question of availability than has been discussed up to now. The Uniform New Payments Code (U.N.P.C.)¹⁹⁸ was developed to replace article 4 and part of article 3 of the U.C.C. The U.N.P.C. was designed to modernize the U.C.C. by providing a comprehensive set of rules to govern paper and electronic payments. The approach taken to the question of availability is of special interest because the delay in return item processing, which is an unavoidable feature of the paper payment system, can be avoided at least with regard to electronic payments.¹⁹⁹ Curiously, the U.N.P.C. provides that customers have no right to withdraw for three days²⁰⁰ after final payment for consumer "draw orders." This is the practical equivalent of a mandatory three-day hold, although it is intended to give consumers the right to reverse payment orders for three days after final payment.²⁰¹ This "cooling off period" is not currently available after final payment for checks under the U.C.C.²⁰² In its present version, however, the U.N.P.C. has

198. UNIFORM NEW PAYMENTS CODE (Permanent Editorial Board Draft No. 3, 1983) [hereinafter cited as U.N.P.C.].

199. The U.N.P.C. applies to a full spectrum of payment media: checks, cashier's checks, wire and telephone transfers, point of sale transfers, automated teller transactions, and other electronic fund transfers covered by the Electronic Funds Transfer Act, 15 U.S.C. § 1693a(6) (1982). U.N.P.C. § 10 order, purpose and existing law.

200. U.N.P.C. § 421(1) establishes that when payment for an order becomes final, the account institution becomes a debtor to its customers for the amount of the order and follows U.C.C. § 4-213(3) (1978). U.N.P.C. § 421(2)(a), (b) establishes when a customer is entitled to withdraw as of right: "When such payment becomes final and the account institution has had a reasonable time to learn that payment is final, but *in the case of a consumer drawer, in no event sooner than three business days from the time of final payment* as provided by Section 420(1)(c)." U.N.P.C. § 421(2) (emphasis added).

201. U.N.P.C. § 425 (applicable to orders of \$50 or more).

202. Under U.C.C. § 4-303(1) (1978), final payment terminates the customer's right to stop payment.

exempted "written draw orders" (checks) from this generous three-day period of reversability.²⁰³ The hold of three days after final payment applies to written and electronic "draw orders." Thus, the U.N.P.C. in its present version contains the anomaly that consumers who have chosen to use checks may not take advantage of the three-day cooling off period to reverse the item, but they are burdened with the disadvantage of what is sure to become a mandatory hold of three days because under this provision they have no right to withdraw before that time.

Apparently, this problem is simply a drafting oversight, because the comments following section 425, on stop payment or reversal of orders, focus on the need for generous provisions for consumers who wish to change the balance of power in negotiations with merchants.²⁰⁴ Even if this oversight is corrected in the next draft, it is worth noting that the present draft would place consumers who choose to use checks in a *worse* position than is now the case under the U.C.C. section 4-213(4)(a).

Variation by Agreement

An important objective of any legislation in this field should be to withdraw the financial service industry's opportunity to use form waivers and standardized clauses concerning availability. As discussed above,²⁰⁵ through the operation of sections 1-201 and 4-103, such clauses are virtually immune from judicial review. Fortunately, this defect is the easiest to cure. The legislature can provide that the standards for availability cannot be varied by agreement.²⁰⁶ This straightforward solution ensures that the statutory or regulatory standards are uniformly available.

There remains, of course, the question of whether the mandated maximum times can be shortened by agreement. This issue, too, can be handled easily by a provision that allows the depository bank to make the funds available on a shorter schedule if it chooses to do so.²⁰⁷

The Method of Return

Every major study of the check collection system has concluded that banks could be required to use the most expeditious route and means for

203. U.N.P.C. § 425(2)(b) (providing for right to reverse payment order "*unless* [such order] . . . is a written draw order transmitted for payment to the payor account institution" (emphasis added)).

204. U.N.P.C. § 425 comment 2.

205. See *supra* notes 173-78 & accompanying text.

206. See, e.g., CAL. COM. CODE § 4213(4)(a) (West Supp. 1984); N.Y. BANKING LAW § 14-d (McKinney Supp. 1984-1985).

207. See, e.g., CAL. ADMIN. CODE tit. 10, R. 10.190404 (West Supp. 1984); N.Y. ADMIN. CODE tit. 3, § 34 (1984).

returning items.²⁰⁸ The fleets of jet couriers that are now employed in collection could be used to return items. Of course, the attractiveness of this change depends upon consolidation of returned item processing to enhance the economic benefits of using faster means of transportation. Several experiments now in progress within the Federal Reserve system²⁰⁹ have as a central feature the use of the Fed's check clearing facilities as a regional hub for return items. Under these proposals, the Fed would accept an item for return processing, even when the item was not initially processed through the Fed. In addition, after the item was accepted for return, the Fed would then send the item directly to the Federal Reserve Bank nearest the payor. This approach thus avoids the problem of having to retrace the initial, often circuitous route taken during initial processing.

Given the longstanding unanimity²¹⁰ within the banking industry that payor and collecting banks must be charged with a duty to use the most expeditious route and means for processing returned items, the following amendment to the U.C.C. section 4-202²¹¹ should be taken up by the Permanent Editorial Board:

[1]: *A collecting bank must use the most expeditious route and means of presenting and returning an item.*

208. See, e.g., NOTIFICATION PROCEDURES, *supra* note 2, at 10-11; RETURN ITEM TASKFORCE REPORT, *supra* note 2, at 2; see also Clarke, *Check Out Time for Checks*, 22 BUS. LAW. 931, 932 (1966) (expressing impatience with lengthy check-clearing procedures).

209. The Dallas Federal Reserve Bank began a direct return experiment in 1980. The program holds great promise, but it has not been fully implemented and is still too new for critics to determine whether it will serve as a national model. Telephone interview with Mr. Swett, General Counsel, Dallas Federal Reserve, June 26, 1983.

One legal barrier to the program's success is the U.C.C.'s requirement that items be physically returned to each prior endorser. To alleviate that problem, Regulation J could be amended to permit depository banks to return items through the Fed nearest the depository, which would then forward them to the Fed nearest the payor. To date, however, Regulation J has not been so amended, thus leaving the legal status of items processed under this arrangement somewhat in doubt.

There is, of course, another option. U.C.C. § 4-103(1) (1978) permits the U.C.C. to be varied by agreement as long as the agreement does not disclaim responsibility for exercising good faith or due care. Therefore, a comprehensive participation agreement could be adopted for such experiments during the interim before Regulation J is amended to permit such arrangements explicitly.

Finally, there is the uncertainty concerning what warranties might arise from the Fed's handling of return items, especially those that it did not initially handle.

210. See, e.g., Position Paper, *supra* note 2, at 197.

211. U.C.C. § 4-202(1) (1978) currently provides:

- (1) A collecting bank must use ordinary care in
 - (a) presenting an item or sending it for presentment; and
 - (b) sending notice of dishonor or non-payment or returning an item other than a documentary draft to the bank's transferor . . . after learning that the item has not been paid or accepted, as the case may be; and

[2]: *In addition to the duties stated in [1] of this section, a collecting bank must use ordinary care in . . . [retain the current language.]*

To impose the same duty upon payor banks, the following amendments should be made to section 4-302:²¹²

[c] items covered by (a) and (b) above if the payor bank fails to use the most expeditious route and means to return such item.

The proposed amendments place the primary responsibility for selecting the most expeditious route for return upon the payor bank.²¹³ This responsibility is entirely appropriate because the payor bank knows first that an item has been dishonored. If the payor chooses simply to meet its midnight deadline by dropping the item in the mail, others in the chain have no incentive to use a more efficient route. In addition, the payor, as the first point in return, is the optimum place to exert the most pressure to accomplish the desired objective. Moreover, the sanction chosen, accountability for an item that has not been sent by the most expeditious route, is substantial enough that the duty thus created will in all likelihood be honored.

Direct return can provide an even more important contribution to the solution of return item problems than expedited methods of return

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- (c) settling for an item when the bank receives final settlement; and
 - (d) making or providing for any necessary protest; and
 - (e) notifying its transferor of any loss or delay in transit within a reasonable time after discovery thereof.

The proposed amendment would add a new subsection (1) and renumber current subsection (1) as subsection (2).

212. U.C.C. § 4-302 (1978) currently provides:

In the absence of a valid defense such as breach of a presentment warranty . . . , settlement effected or the like, if an item is presented on and received by a payor bank the bank is accountable for the amount of

- (a) a demand item other than a documentary draft whether properly payable or not if the bank, in any case where it is not also the depository bank, retains the item beyond midnight of the banking day of receipt without settling for it or, regardless of whether it is also the depository bank, does not pay or return the item or send notice of dishonor until after its midnight deadline; or
- (b) any other properly payable item unless within the time allowed for acceptance or payment of that item the bank either accepts or pays the item or returns it and accompanying documents.

213. This would be consistent with those cases interpreting U.C.C. § 4-302 (1978) as imposing strict liability upon the payor bank for failing to return or give notice within the midnight deadline. *See, e.g.,* Appliance Buyers Credit Corp. v. Prospect Nat'l Bank, 708 F.2d 290 (7th Cir. 1983). The depository bank's failure to notify its customer in a timely manner of a dishonored item subjected the bank to liability only for "actual damages." The court reasoned that despite § 4-302, the depository/collecting bank was not accountable for late notice or return. *Cf. Great W. Bank & Trust v. Nahat*, 37 U.C.C. Rep. Serv. (Callaghan) 209 (Ariz. App. 1983); *Bank of Commerce v. De Santis*, 451 N.Y.S.2d 974 (N.Y. Civ. Ct. 1982) (notice after midnight deadline permissible due to Christmas holiday).

because direct return, even when mails are used, avoids the long trail of prior endorsements created by circuitous routing. Thus, a payor bank that elects to return items directly to the depository can cut seven to ten days off the time for return, even if it decides to mail the item. The option to return an item directly to the payor bank is now available under section 4-212.²¹⁴ Under this section a payor/drawee bank and intermediary banks may return an item directly to the depository bank, thus avoiding the hazards of returning items through the initial chain of collection. The drawee choosing this option may expedite reimbursement for the provisional credit by sending the item with a draft for collection, drawn on the depository.

The dramatic increase in the number of large value checks that have been processed initially through an intentionally indirect, circuitous route underscores the importance of direct return. These checks are often sent through an above average number of banks in an effort to extend the period of time during which the drawer can make other use of the funds in the account.²¹⁵ The remote disbursement practice has pro-

214. This option was not adopted in several states. For example, in California, nonuniform comments were added which criticized the new section. CAL. COM. CODE § 4212 comment 1 (West 1964). California adopted § 4-212(2) as part of the 1984 Delayed Availability Law.

215. Circuitous routing has always been a growth industry in banking. See W. SPAHR, *supra* note 36, at 105-07; Turner, *supra* note 47; Ross, *supra* note 39, at 75. In recent times many companies have sought to take advantage of the delay which is inevitable in processing checks. The practice is variously known as "controlled disbursement" or "remote disbursement." An illegal version of this practice was the source of federal indictments against E.F. Hutton. See Bleakley, *How Hutton Scheme Worked*, N.Y. Times, May 17, 1985, at 31, col. 3; Pasztor & Murray, *Hutton Case Said to Involve More Money, Which May Require Larger Restitution*, Wall St. J., May 6, 1985, at 3, col. 2; Pasztor & Ingersoll, *E.F. Hutton & Co. Enters Guilty Plea to Charges of Check-Writing Fraud*, Wall St. J., May 3, 1985, at 3, col. 2.

What follows is an explanation of how "controlled disbursement" works: A company seeks to gain extra time for disbursing funds from its checking account. This can be accomplished by paying its vendors with checks drawn on a bank selected because it is far away from the corporate depositor. If a corporate treasurer can find a bank willing to provide the service of routing its checks through a series of country correspondents in order to delay finality, the time gained may be financially rewarding. This should not be too difficult because there are reported to be over 130 banks which offer this service. Ross, *supra* note 39, at 76. One recent survey indicates that of 1217 large companies, 59% maintained controlled disbursement accounts in 1982. This was an increase from 49%, two years before. *Id.* One company—Foremost-McKesson—by its own calculation earned 5.5 million dollars through use of a sophisticated remote disbursement accounting practice.

The remote disbursement service typically includes a telephone call to the corporate customer each morning stating the amount needed to cover the checks which will be cleared on that day. Thus, the account balance can be maintained at the lowest level needed to cover corporate obligations. These accounts are called "zero balance" accounts because they contain no cash at the end of the day after all checks are paid. This permits the corporation to use the cash, which would otherwise be idle, for investing in more profitable arrangements. *Id.*

voked a strong disapproval from the Federal Reserve. The Fed reasoned that the practice denied consumers and small businesses "prompt access to funds" and undermined the Fed's efforts to improve the speed and efficiency of the check clearing system. Thus, the advent of remote-controlled disbursement provides an additional reason why direct return should be encouraged. Direct returns would avoid the problem of adding further to the delay created when an item has been sent forward under an intentional "race to the slow payer."

Endorsement Standards

Several proposals suggest that changing the technology for handling checks during the process of return will lead to tangible improvement.²¹⁶ Each of these suggestions is sensible; this section will only describe the areas and techniques which are suitable for change rather than criticize the merits of the suggestions. One obvious opportunity for improvement is the placement of endorsement. Today, endorsements are placed on the back of a check in no particular order and often overlap, making it difficult to read them. Against this background, the attractiveness of the proposal to assign areas on the reverse of checks for imprinting by the bank of first deposit becomes apparent. The bank of first deposit is clearly the most important link in the chain of return because it must bear the responsibility for notifying its customer that a deposit has been dishonored. Reserved space for the depository's endorsement will reduce and perhaps eliminate the problems with obliteration described above.

Carrier Envelopes

Carrier envelopes with preprinted MICR strips bearing the routing symbols for the depository could further reduce the level of error in return item sorting. Canadian banks have already adopted this kind of system, with some success.²¹⁷ MICR encoded carrier envelopes for direct return to the depository have the advantage of providing a method for high speed sorting of returned items in bulk. This change would help to eliminate the errors which now occur because each return item is handled individually.

Ownership of Interest

The delayed availability debate centers on bank customers' right to use the proceeds of checks that are in the process of collection. When a

216. See, e.g., Position Paper, *supra* note 2.

217. RETURN ITEM TASKFORCE REPORT, *supra* note 2, at 10.

customer deposits a check that eventually will be honored, the bank may accrue the immediate benefit of including that sum in its reserves and drawing interest on it.²¹⁸ If the customer is not entitled to interest until the check is considered paid, there may be a substantial period during which the bank earns interest without paying any interest to the customer. In effect, the bank receives an interest-free loan from the customer. A successful legislative approach to delayed availability must determine when a consumer is entitled to interest on his deposit.

There are at least three possible approaches to the problem. First, a depositor might earn interest from the day of deposit even though the funds were not available for withdrawal.²¹⁹ In the event the check was returned unpaid, no interest would be credited.²²⁰ Only interest-bearing accounts would benefit from this approach. A second approach would permit financial institutions to hold funds without interest payments for a fixed period, after which the bank would be required to pay a statutorily fixed high interest rate as a penalty. This financial penalty might diminish the profitability of lengthy blanket holds. Such a proposal, however, would entail substantial administrative expenses. In addition, "pricing" float²²¹ in this way would simply treat the symptom without curing the principal cause of the problem: slow return item processing. Finally, the period designated as a reasonable time would certainly be-

218. See *supra* note 65 & accompanying text.

219. The California legislation took this approach:

For the purposes of computing the amount of interest or dividends payable with respect to an interest-bearing deposit account, a depository institution shall not delay beginning to compute interest on funds deposited by check . . . beyond the date on which that depository institution receives provisional credit for the check or similar instrument. However, the payment of interest with respect to funds deposited by check or similar instrument which is returned unpaid shall not be required.

CAL. FIN. CODE § 866.3 (West Supp. 1985).

220. If delayed availability reform is intended to correct the existing imbalance between consumers and financial institutions, the second option is preferable. Any interest earned by the customer before the depository is credited with the item would be a windfall. In the light of other reform provisions, such a situation would shift the balance of the risk to the financial institution. It is therefore fair to defer crediting the interest until the institution begins to receive some financial advantage from the transaction.

Should proceeds subject to legitimate holds earn interest during the period of the hold? If the account is otherwise entitled to earn interest, interest should be earned during the hold period. Such interest could be credited either from the date of the deposit or from the date the depository is given a provisional credit.

There is another option, which I have omitted, thus revealing my bias. The banks could refuse to grant interest at all. This option has been wisely rejected in those jurisdictions considering the question.

221. This approach would be akin to the pricing of federal reserve float. See *supra* notes 83-84 & accompanying text.

come the *minimum* time, even for those items that could be granted early availability. Thus, many depositors would be worse off than before.

A third approach attacks the problem from the opposite direction. Legislation could require standard, brief holds—two or three days—for all items, and financial institutions could charge a low rate of interest to all depositors to compensate for the risk of returned items.²²² This proposal, however, also fails to address directly delays in return item processing. A depositor who might be entitled to immediate availability if legislative standards were adopted would, under this proposal, be subject to some delay and the additional burden of interest payments.

In summary, enactment of the legislative solutions discussed above would certainly improve the present imbalance.²²³ In fact, in view of the long delays in the implementation of voluntary proposals made by the financial services industry, legislative solutions, properly conceived, have the greatest potential for true reform.

Conclusion

This Article has demonstrated that while check collection has entered the modern age, return item processing remains in the Stone Age. The delay in the availability of funds drawn against checks results from inefficiencies in the method currently used to process return items. Moreover, the banking industry's policy of placing blanket holds on deposited checks is not justified by the banks' risk of loss from dishonored items.

The Article has sought to chart a path into the modern era by advocating legislative intervention to end the unfairness of delayed availability of funds and to improve the efficiency of the system for processing return items. Reform is necessary in several areas: disclosure of the hold policy to a bank's customers; notification of the hold; direct return to the payor bank; and increased use of modern technology for rapid communication. Several proposals are offered to remedy the problem of return item processing. These proposals will be most effective if they are incorporated in the U.C.C.

222. This approach would be consistent with Senator Dodd's suggestion: "How about a system of 3-day credit to the depositor and permit banks to charge interest?" *Delayed Funds Availability Hearings*, *supra* note 5, at 29.

223. All of the legislative proposals and laws to date provide for some civil penalty. *See, e.g.*, S. 573, 98th Cong., 1st Sess. § 9(a) (1983) (providing for civil liability of not less than \$50 or more than \$500 for individual plaintiffs; civil liability up to \$500,000 or 1% of the bank's net worth (whichever is less) in class actions; and costs and attorneys' fees for either kind of enforcement action).